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PENSION FUNDING PROBLEMS

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PENSION FUNDING PROBLEMS

MONDAY, JUNE 7, 1982

U.S. HOUSE OF REPRESENTATIVES,
SELECT COMMITTEE ON AGING,
Washington, D.C.

The committee met, pursuant to notice, at 10:00 a.m., in room 2226, Rayburn House Office Building, Hon. Claude Pepper (chairman of the committee) presiding.

Members present: Representatives Pepper of Florida, Mica of Florida, Synar of Oklahoma, Hammerschmidt of Arkansas, Daub of Nebraska, and Hendon of North Carolina.

Staff present: Charles H. Edwards III, chief of staff, Roger Thomas, pension counsel, Marie Brown, executive secretary, Rita Coleman, secretary, Gail Jimerson, deputy minority staff director, and Kathy Dooley, majority staff intern.

OPENING STATEMENT OF CHAIRMAN CLAUDE PEPPER

The CHAIRMAN. The committee will come to order.

In 1974, Congress enacted the Employee Retirement Security Act, ERISA, to protect workers covered by pension and welfare benefit programs offered by their employers and employee organizations. This law was enacted to protect the millions of American workers who look forward to and will rely on their pensions to support them upon retirement.

You know, at the present time, it is estimated that only about 25 percent of the people who retire from work have any pension coverage at all. Then you will remember, the question of vesting, how long it takes from employment for the pension to vest.

Then there is the matter of the worker moving from one place to another; there are a number of problems involved in trying to assure the workers of the country a decent pension upon retirement as a supplement to their social security benefits they receive, and whatever savings they may have.

ERISA seeks to protect these workers through the imposition of certain standards, which include:

One, the minimum funding of pension plans; two, the prudent administration of the plan and its assets; and, three, the provision of plan termination insurance administered by the Pension Benefit Guaranty Corporation.

Our hearing today will examine several of the problems associated with the funding of private pension benefit plans which threaten the financial security of the millions of workers and retired persons who rely on their retirement benefits.

The current recession threatens the security of the Nation's private pension system. Only several weeks ago, Braniff International became the first major airline to ever go bankrupt, and that company left as its legacy $70 million in unfunded pension obligations which eventually will have to be assumed by the Pension Benefit Guaranty Corporation.

To show you the ramifications of such a matter, for a number of years a wife of a Braniff Airline captain had been a member of my staff in my Miami office. She, a little while ago, decided that for health reasons she would like to retire.

Her husband was receiving a pension from Braniff and they also were covered by health insurance, due to Braniff paying into an insurance company which provided the health care coverage.

After she had retired, and we had employed another lady who had given up a job in order to take our position, the lady who is the wife of the retired Braniff Airline captain came back and asked for her job back. We said, of course, we couldn't do it, because we had already employed the other lady who quit her job in order to come here.

We asked what was the problem? She said,

> You know, my husband is retired as an airline captain from Braniff. He may not have his pension any more, and we understand if Braniff is unable to pay into the insurance company, we won't have health care coverage any more, so I want to get back on the government payroll so we will have some kind of health care.

People were calling me from the Braniff employee organizations, asking what was going to happen to their pension? This is one of the things we are going to discuss this morning. It shows how many people are dependent upon these pension programs.

With such a burden and the specter of additional major bankruptcies lying on the horizon, there is some question as to whether the PBGC, the quasi-Federal corporation which insures pension benefits of bankrupt employers, will itself survive in its present form.

With the recent bankruptcy of Braniff, there are some who suggest that the PBGC may, if further bankruptcies occur, itself face fiscal bankruptcy. I believe that the Congress must insure that this corporation will continue its mission to protect the employees and families of bankrupt employers and their pension plans.

By the way, presumably if there is one more bankruptcy of the size of Braniff, that Government insurance corporation will not be able to meet its obligations.

Where pension plans have been allowed to become overfunded, such as in the instance of the Harper and Row and the A&P stores plans, the management of these employers have apparently been tempted to threat these pension plans like their own personal piggy banks, greedily breaking into them, and raiding them on that rainy day of their own financial difficulty, arbitrarily terminating the pension system, and taking over the assets.

I cannot believe that Congress intended that employees and their families should have to face the demise of that sacred promise of a pension in such an unexpected and unseemly way. Although we may find that the present laws do not prevent or frustrate this behavior by some employers, I believe it may be time for Congress to develop legislation which will insure the continued integrity of the pension promise.

A workman, having paid in all of his working years, then he finds when it comes time for him to receive his pension, finds that his company is bankrupt, and the pension funds are inadequate or nonexistent, and even the Government insuring agency may not be able to fulfill its obligations.

We will hear from representatives of the Federal agencies who are charged to act as guardians of pensions and discuss their ability under the current law to meet these challenges.

But first, we will hear from a panel of pension experts who will present an overview of the pension plan and the problems with current funding practices that are emerging today.

Mr. Synar, do you care to make a statement?

Mr. **SYNAR**. Mr. Chairman, I have no opening statement, but I would like to take this opportunity to commend Chuck and the staff. I think this is an excellent area we ought to stress. I think the staff that has done a tremendous job in creating a good group of witnesses with excellent briefing materials.

I compliment the staff for their work.

The **CHAIRMAN**. Mr. Hendon?

Mr. **HENDON**. I have nothing.

The **CHAIRMAN**. Mr. Daub?

PREPARED STATEMENT OF REPRESENTATIVE HAL DAUB

Mr. **DAUB**. Mr. Chairman, I personally want to commend you for starting off on this road to examine our underfunding question. It has been said, as you know, that there is as much as a $7 trillion underfunding of the pension obligations that are currently due or could be due to those who have been employees in the corporate form.

As you know, it was my major suggestion that we explore this area because I have had the privilege as an attorney for management to work on 54 pension and profit-sharing plans, I have some familiarity with the area and think that we need to focus the public's attention on the potential impact of underfunding of the private pension plan system.

Retirement income is said to emanate from three basic sources, from social security, from private pension plans, and from individual savings and/or investment income.

Congress, to the extent we have the authority over aspects of private pensions and social security must monitor these moneys and the investment of these moneys to insure that those who are relying on these future benefits will, in fact, receive them.

Underfunding of private pension plans is a serious fraud that is going on at this very moment, and which, unless we indicate an intolerance to it, will multiply and proliferate in the years ahead.

It is a fraud with a potentially devastating impact on our Nation's elderly of today as well as tomorrow. Besides the underfunding question I find there is a serious problem with the investments that are made by pension trustees and the lack of information provided to beneficiaries under these plans.

I commend you again, as well as the staff. I am sure Mr. Hammerschmidt, our ranking member, will be here shortly and will have a statement. I look forward to listening to the witnesses who will be before us today.

The CHAIRMAN. Thank you very much, Mr. Daub. I have Mr. Hammerschmidt's prepared statement here, and if there are no objections, I would like to submit it for the record at this time. Hearing none, so ordered.

[The prepared statement of Representative John Paul Hammerschmidt follows:]

PREPARED STATEMENT OF REPRESENTATIVE JOHN PAUL HAMMERSCHMIDT

Mr. Chairman, I want to thank you for convening this hearing to call attention to an issue that appears to be growing in seriousness before our very eyes—pension plan funding practices. None of us here, I'm sure, would disagree with the statement that the questions raised by an in-depth discussion of these funding practices have profound implications for the labor force, those individuals looking forward to a financially secure retirement, management and current retirees.

We've all heard the frightening statistics that have recently appeared about the extent to which businesses are experiencing severe financial difficulties. Many of these businesses are closing their doors after many years of operation. Obviously, this means there is a great deal at stake for all the participants involved in retirement benefit plans. Questions need to be answered about unfunded liabilities on one hand and benefit payments to employees on the other. Before these questions can be answered, I believe we must look closely at the very essence of private pension plans to determine whether our retirement pension system contributes to or resolves the financial difficulties of American businesses and their employees today.

Mr. Chairman, I don't think we can afford to lose any time in examining the present condition of private pension plans and the issues that surround them. I appreciate having the opportunity to be here today and look forward to the testimony of our distinguished witnesses.

The CHAIRMAN. As Mr. Daub mentioned, Congressman Hammerschmidt will be joining us very shortly.

Now, I would like to call on our first panel. Gentlemen we are pleased to have you here. We appreciate your coming, and Mr. Gordon, we will welcome your statement.

By the way, gentlemen, I would like all the witnesses to know that those of you who have written statements, we will be pleased to put them in the record in full, and let you summarize your statement, if you should care to do so.

I do think that enables the committee to ask more questions of the panel than we otherwise might.

Mr. Gordon, we welcome your statement.

PANEL ONE, CONSISTING OF MICHAEL GORDON, PENSION ATTORNEY, MITTLEMAN & GORDON, WASHINGTON, D.C.; THOMAS WOODRUFF, FORMER DIRECTOR, PRESIDENT'S COMMISSION ON PENSION POLICY; AND WILLIAM PRIEST, VICE PRESIDENT, BEA ASSOCIATES, INC., NEW YORK, N.Y., ACCOMPANIED BY PATRICK J. REGAN

STATEMENT OF MICHAEL GORDON

Mr. GORDON. Thank you, Mr. Chairman. I will try to be as concise as I can, and summarize my statement.

Mr. Chairman and members of the committee, my name is Michael S. Gordon. I am a member of the law firm of Mittleman & Gordon, a Washington, D.C. firm that specializes in the employee benefits field. During the period 1970 through 1975, I was Special Minority Counsel for Pensions to the U.S. Senate Committee on Labor and Public Welfare and participated in the drafting of ERISA. Prior to that experience, I had also served as the Department of Labor's counsel to President Kennedy's Cabinet Committee on Corporate Pension Funds, which issued a report in 1965 that laid the groundwork for subsequent private pension reform legislation.

I appreciate this invitation to appear and provide some background on the funding and termination insurance provisions of ERISA. I was a little bit surprised. Frankly, I knew that the Chairman was a stalwart and heroic legislative figure, but even I didn't realize how heroic you were in wanting to learn about the legislative background of ERISA.

That is true grit, Mr. Chairman.

As you know, there are two kinds of legislative history. There is the kind that the courts generally rely on which consists of the language of committee reports, et cetera. That is the official version. Then there is the unofficial kind which more or less centers on the problems, the controversies and the compromises that were considered and rejected or accepted.

In my opinion, the latter kind is generally more useful to legislators because, unlike the courts, legislators realize that enactment of a bill, even one like ERISA, does not lay the controversies to rest.

They keep on coming, they keep on evolving, calling for constant legislative evaluation.

That is true about funding and termination insurance. The controversy surrounding those provisions as they came into being in ERISA are, to a large extent, still with us. In fact, some of them have barely altered their shape since 1974.

It is clear that termination insurance is exceedingly vulnerable now and that the fragile consensus that brought these provisions into being is getting more shaky all the time.

You know, back in 1974, we had a somewhat more optimistic view of the economy than perhaps we have today. When ERISA was enacted, I don't think anyone realized that we were going to be confronted with such devastating economic problems, the potential disintegration of the industrial heartland of this country.

All this puts an enormous strain on the termination and funding provisions that were enacted in ERISA.

Now, these provisions came into being primarily because of the Studebaker situation back in 1963. In 1963, Studebaker terminated its automobile assembly plant in South Bend, Ind., and approximately 4,400 workers lost all or part of their vested pension benefits.

That was a tremendous social tragedy. Some workers even became suicidal and some in fact committed suicide as a result of that. It really focused for the first time the public concern over how reliable the private pension promise was.

In the aftermath of that debacle two theories developed. One theory was that the way to assure that pension benefits were fully protected was to make sure that there were systematic funding standards in place.

Prior to 1974, pension plans were only required to fund what was known as their current service liabilities and the interest on their past service liabilities. They weren't actually required to fund the principal of those past service liabilities themselves.

The result was that an enormous number of plans, both in the single employer field and in the multiemployer field had built up huge unfunded past service liabilities and the more the plan was amended to improve those benefits, the larger the gap would grow between the amount of assets on hand and the amount of liabilities that were being projected.

Employers did not have any legal commitment to fulfill the funding of those liabilities or to pay them off. Their legal obligation was limited to contributions actually paid into the plan.

However, another school of thought realized that you could not force employers to fund these past service liabilities very rapidly because the amounts were so large it would probably discourage the continuation of these plans and certainly their improvement.

It was recognized that funding, if it was going to be systematic, would have to take place over some period of time. It was more or less like paying a mortgage on your house. You can't pay it all at once, you have to pay it over a period of time.

So it became clear that in order to deal with this Studebaker-type situation, you needed some program of insurance to protect against the unforeseen possibility that an employer might face economically adverse circumstances and be compelled to terminate the plan, even though he had been trying to fund, as indeed Studebaker had been trying to fund, on a systematic basis.

It was further recognized that if you wanted to establish such a termination insurance program, then in order to prevent there being an incentive for folks to promise the sky and then terminate their plans and dump all their responsibilities on the insurance system, that at least you would need some type of termination insurance program coupled with funding standards. As Senator Javits put it, at the time, if you didn't provide funding standards along with termination insurance, you were really insuring a pig in a poke.

The early bill that was drafted made it a point to limit the exposure of PBGC to this problem of potential dumping by restricting insurance only to those liabilities that were created after the enactment of the law—and when the results of that became known, there was a furor because it was realized that the effect of the termination insurance program probably wouldn't be realized for another decade, primarily because the vesting standard that was being considered then was 10-year vesting, so these new vested liabilities that would have been created really would not have been insured for another 10 years.

Meantime, plans could collapse and there would be no insurance. So the drafters of ERISA were compelled to confront the problem of how do you deal with this situation of insuring rather substantial, not to say huge liabilities that had been built up historically for which there had been no adequate funding standards.

The solution to this problem was something called employer liability, which is to say that, contrary to the prevailing rules of the game that had been established then, ERISA proposed to—or at least the early drafts—proposed to place on an employer, continuing liability for being responsible for paying off unfunded vested liabilities, even after the plan had terminated. However, subsequently, it was realized that the full imposition of that liability would create a number of very extraordinary credit-worthy problems for corporations all over the country, and would potentially discourage employers from continuing to maintain or improve these plans. And so the final compromise that was reached in ERISA on this subject was to limit employer liability exposure after termination of the plan to 30 percent of his net worth.

In regard to trying to construct the premium structure for this termination insurance program, a choice was presented between making the premium structure somehow risk related and making the premium more uniform and easy to administer. Originally, it was thought the best way to proceed was to make it risk related, because that would encourage a greater incentive to fund more quickly, and the original formula would have set a premium based on the difference between a plan's assets and its unfunded vested liabilities and the greater the gap the greater the premiums that would have to be paid; the smaller the gap, the smaller the premium that would have to be paid.

This version was supplanted later on by a per capita approach. The per capita approach was taken, because it was simpler to understand and administer, and because it not put as great a strain upon those plans which historically had developed huge unfunded liabilities.

That brings us up to today. We can see that the results of these various compromises did not, and could not, fully take into account the kind of adverse economic developments that the chairman has referred to. It is clear that something has to be done about increasing the amount of reserves that PBGC has available in the event of plan terminations.

In my opinion, as far as premiums are concerned, we ought to combine the per capita tax with some type of risk-related premium. I don't feel that a risk-related premium, based upon a difference between assets and unfunded vested liabilities is particularly appropriate because it really doesn't take into account the type of problems that a particular industry may be experiencing. A plan may have a very large funding ratio, that is, the difference between assets and unfunded vested liabilities may be greater, but that may not be something to worry about because the industry it is in may be healthy.

I feel a premium ought to be a two-tiered approach based first on the per capita tax and then some type of industry classification risk system which means that plans in troubled industries would have to pay a higher premium than plans in relatively well-off industries. I think that that is consistent with sound insurance principles, and would build up more adequate reserves.

With regard to dealing with the so-called dumping problem, there have been efforts, particularly since the enactment of the multiemployer amendments in 1980, to try to remove the 30-percent net worth limitation in the single employer field, and go to what is called an insolvency system, which is more or less a euphemism for 100 percent employer liability after termination.

The problem I have there is essentially the problem that has arisen in context of the multiemployer amendments, which is that it requires employers to expose themselves to rather significant amounts of large unfunded liabilities which were created for the most part, prior to ERISA, when the rules of the game with regard to funding were entirely different.

For many of them, this may be too much to swallow, and it may be unnecessary to go down that route. I think if we have strong antidumping measures in the termination insurance provisions, something that would not let an employer get away with simply terminating his plan for purposes of dumping liabilities on the termination insurance system, that that may adequately deal with the problem without undermining the incentive for employers to continue to maintain these plans.

Finally, I would say that, in general, I think that it is important to try to maintain as much as possible the type of protection of benefit levels that have been enacted in ERISA. Many of you may know that the 1980 multiemployer amendments lowered the amount of benefits that would be insured. I think in part that was due to the difference between industrial plans and the multiemployer plans, although I am not sure that it is entirely warranted anyway. In any event, as far as the industrial plans are concerned, to the extent benefit levels previously promised as guaranteed under the insurance system by ERISA, are set back or lowered, I think that it would have an absolutely demoralizing effect on participants in these plans who have been led to believe that in the event of termination, their benefits would be protected at a much higher level.

Therefore, I think every effort should be made to try to find a solution to building up the reserves in the termination insurance program without on the one hand exposing employers to the point where their desire to maintain the plans starts to disintegrate and, which, on the other hand, would sustain the levels of benefit protection to which the Congress has already committed itself.

Thank you, Mr. Chairman and members.

[The prepared statement of Mr. Gordon follows:]

PREPARED STATEMENT OF MICHAEL S. GORDON, ESQ.

Mr. Chairman and Members of the Committee, my name is Michael S. Gordon. I am a member of the law firm of Mittleman and Gordon, a Washington, D.C. firm that specializes in the employee benefits field. During the period 1970 through 1975, I was Special Minority Counsel for Pensions to the U.S. Senate Committee on Labor and Public Welfare and participated in the drafting of ERISA. Prior to that experience I had also served as the Department of Labor's counsel to President Kennedy's Cabinet Committee on Corporate Pension Funds which issued a report in 1965 that laid the groundwork for subsequent private pension reform legislation.

I have been requested to comment on the conceptual origins of ERISA's funding and termination insurance requirements on the assumption that such an exercise may shed some light on current matters of concern with respect to these provisions.[1] There can be little doubt that a searching reappraisal of ERISA's funding and termination insurance provisions is urgently needed. The recent collapse of Braniff Airlines and the financial troubles of Chrysler and International Harvester have focused attention on the potential vulnerability of PBGC in the single employer insurance area. Unfortunately, the 1980 multiemployer termination insurance amendments have not been successful in becoming a stabilizing force in that field; instead, the 1980 law has provoked a massive attack on its constitutionality, has left many multiemployer plans in disarray, and perhaps has even endangered the fundamental consensus that brought ERISA into being. Despite the need for legislative action that will correct shortcomings in ERISA and the 1980 amendments, it should be apparent to all that the greatest caution must be exercised in attempting further changes in order to avoid lasting fragmentation of that consensus.

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[1] The views expressed in this testimony represent my personal views and should not be necessarily attributed to any of the clients of Mittleman and Gordon.

One of the principal elements of the ERISA consensus was the desire to strengthen defined benefit pension plans. It would be tragic indeed if legislative efforts to achieve that objective only succeeded in irreversibly damaging these plans—a classic case of the cure being worse than the disease. Prior to 1974 the defined benefit plan was the most potent instrument of private pension growth in the United States. A defined benefit plan was popular because it had the flexibility to accommodate the need of an employer to provide retirement benefits to older members of his work force (so-called "past service" benefits) while at the same time adjusting through its benefit formulae, particularly through final-pay or similar approaches, to inflationary forces. Historically speaking, the growth of the defined benefit plan was a response not only to favorable tax incentives but also the fact that Social Security by itself was perceived almost universaly as grossly inadequate to meet the retirement needs and expectations of workers in most industries. Between 1950 and 1970, substantial numbers of Americans had begun to rely heavily on defined benefit pension plans to furnish them with the means to live decently in their retirement. This dependence stimulated an even greater expansion of both the plans and the benefits provided under them.

Unfortunately, there was a serious flaw in this otherwise promising development. Defined benefit plans were not always reliable deliverers of the benefits they promised. This proposition was illustrated most vividly in 1963 when Studebaker shut down its automobile assembly plant in South Bend, Indiana and terminated its collectively-bargained defined benefit pension program for those workers. Over 4,400 Studebaker employees with vested benefits lost all or a substatial portion of those benefits. Many of these employees were over 50 years old, and, as a practical matter, they had lost their chance for a private pension from any source. Some ended up social derelicts; there were even a few suicides.

Two dissimilar schools of thought developed in the wake of the Studebaker debacle. One school held that the lack of more stringent funding requirements for defined benefit plans made further episodes like the Studebaker termination inevitable. This school pointed out that IRS funding rules, as they then existed, only required employer contributions to cover current service liabilities plus the interest on past service liabilities; these rules did not require any systematic funding of the past service liabilities themselves. As a result, in most defined benefit plans, there was always a significant gap between plan assets and liabilities, which tended to increase as plan benefits were liberalized. If the plan should terminate, there would almost always be substantial amounts of unfunded liabilities which translated into benefit commitments an employer was not legally responsible for fulfilling. According to this viewpoint, only a systematic funding of past service liabilities would protect against recurrence of the Studebaker situation.

The second and opposing school of thought pointed out that in fact Studebaker had been amortizing its unfunded past service liabilities on a 30-year basis (not just paying the interest), that it was impossible in defined benefit plans to fund the prior service costs assumed by the plan on an immediate rather than long-term basis, and that to attempt to do so would simply discourage the adoption of defined benefit plans as well as deserved increases in benefits. It was further argued that as long as an employer was healthy economically and stayed in business, an excessively rapid funding of past service costs was counterproductive since it diverted employer funds from capital growth and expansion, and that the fundamental problem was how to protect the pension rights of workers when an employer, like Studebaker, was compelled by unforeseen economic circumstances to terminate the plan.

To oversimplify and make a very long story very short, it was the second school of thought that ultimately prevailed and influenced both the adoption of ERISA's termination insurance provisions as well as its funding standards. The drafters of ERISA perceived that since past service costs could never be amortized all at once, minimum funding standards were required not as a direct means of protecting employees in the event of plan termination but rather as a device to protect a termination insurance program against abuse. As Senator Javits put it at the time, to protect employees in a Studebaker-like situation through a system of termination insurance without also imposing some systematic funding standards was like insuring "a pig in a poke," and would result in blowing the insurance premiums sky-high.

The original Williams-Javits pension reform bill reported by the Senate Labor Committee in 1972 attempted to adhere rather closely to this line of thinking. Because no funding standards for past service liabilities had been in place prior to adoption of the bill, the bill, in order to avoid insuring a "pig in a poke," limited termination insurance coverage to those vested benefit liabilities that were incurred after the bill's enactment, i.e., when the bill's funding standards became operative. In addition, a distinction was drawn between funding for liabilities incurred prior to enactment of the bill and afterwards; the former were to be funded on a 40 year basis; the latter on a 30 year basis. There then occurred one of those decisive moments in the legislative history of ERISA which bears directly on current problems and explains to a large extent why efforts to strengthen defined benefit plans through termination insurance can also, paradoxically, weaken the incentive to establish and maintain such plans.

Because the original Williams-Javits bill only insured post-enactment liabilities, it was readily apparent that most employees in most existing defined benefit plans would not be protected in the event of their plans terminating like Studebaker's. Most, if not all of the liabilities involved were pre-enactment and had not been funded in accordance with the new funding standards. This result was unacceptable; it meant the insurance program would not have provided meaningful protection for probably another decade. Thus, the drafters were compelled to address the problem of insuring pre-enactment benefit liabilities, which were substantially underfunded.

In addressing this problem, it was quickly grasped that, absent some control mechanism, the temptation to terminate plans with substantial unfunded pre-enactment liabilities for purposes of transferring those liabilities to the insurance system would be very great, and would cause insurance premiums to skyrocket. In order to avoid such potential abuse a number of safeguards were adopted, the most important and controversial of which was the principle of continuing employer liability after termination for the plan's unfunded vested liabilities. In essence, this principle was regarded as akin to insurance principles of subrogation.

The main difficulty with this principle was that its adoption involved a radical change in the rules of the game. Prior to ERISA, the legal responsibility of employers did not extent to covering a plan's unfunded liabilities but was expressly limited to the contributions made to the plan. All defined benefit plans had been established and maintained on this basis; to suddenly change the premise would have demolished the creditworthiness of many companies and would have discouraged the further adoption of defined benefit plans or needed improvements in their benefit levels. For these reasons, it was ultimately determined to limit an employer's continuing liability after termination to 30 percent of the employer's net worth, and, a modified version of this rule was made applicable to certain withdrawals in multiemployer plans.

The other major element that has immediate relevance to the current situation was the selection of the premium formula for the termination insurance program. The original concept developed was to make the premium risk-related which would have involved either rating companies and/or industries or the plans themselves. At the time the former was regarded as too complex and potentially disruptive to the private sector and, accordingly a version of the latter was chosen. This version required a variable premium to be paid based on the ratio between a defined benefit plan's assets and its unfunded vested liabilities. Theoretically, the greater the gap between assets and liabilities, the greater the risk to the termination insurance program. The corollary of this approach was that it would encourage speedier funding in order to close the gap and lower the premium.

Although a modified version of this approach was retained in the final ERISA product (and is still available for use by PBGC) it was supplanted in the later stages of ERISA's drafting by the per capita premium formula. The per capita approach came to the forefront because it was simple to understand and administer and because it presumably placed less pressure on plans whose historical progress in funding past service liabilities prior to ERISA had been minimal. On the other hand, it was recognized then as now, that the per capita approach is inherently arbitrary and unfair in terms of equitably distributing the risks of insuring unfunded vested plan benefits, and this inherent unfairness becomes more and more oppressive the more premiums have to be increased to cover the growing exposure of PBGC.

Let me now summarize what I believe to be the significant connections between the ERISA background just described and current problems, bearing in mind that I have deliberately omitted some other noteworthy aspects of ERISA's legislative history in order to sharpen the focus on these major themes:

(1) There is no "funding" problem under ERISA. Funding standards were adopted to protect the integrity of the termination insurance program created by Title IV.

To the extent funding standards need to be tightened up they should be done so in the context of improving the functioning of termination insurance, as was the case under the multiemployer amendments of 1980. Since even more stringent funding standards cannot substitute for a plan termination insurance program, the burdens imposed by additional funding requirements have to be measured, as in the case of increased premiums or increased employer liability after plan termination, against the potential for undermining the incentive for an employer to maintain a defined benefit plan. As a personal opinion, the case for further hardening the funding standards as a means of limiting PBGC's exposure seems weak and would appear to cause the greatest disruption in terms of the present state of the nation's economy.

(2) The Congress probably went further than was necessary in connection with employer withdrawal liability under the multiemployer amendments of 1980. Any attempt to copy that approach with respect to amending the single employer termination insurance provisions—at least with respect to non-collectively bargained single employer plans—would compound the error. The argument is now being made that there is even greater justification for removing the 30 percent net worth limitation in single employer plans than existed with respect to the legislating of withdrawal liability under multiemployer plans since in the former case the single employer was always in control of the unfunded liabilities it created whereas in the latter instance, a withdrawing employer may be responsible for assuming liabilities attributable to other employers that the withdrawing employer did not create. While this argument has superficial plausibility insofar as post-ERISA liabilities are concerned, it ignores the fact that the 30 percent net worth limitation was enacted in recognition of the fact that pre-ERISA unfunded liabilities were created when the rules of the game were entirely different.

To the extent that both employer sponsors of single employer defined benefit plans and participating employers in multiemployer plans are now required to absorb liabilities that were created when the funding rules for past service liabilities were virtually non-existent, there is presented an elementary question of fairness[2] which, because of the potential size of these liabilities, threatens to undermine the defined benefit plan system. The $64 question is whether eliminating the 30 percent net worth limitation is really necessary to protect PBGC against termination abuse and continued rises in premiums. I think the evidence is far from clear on this point, and that a 30 percent net worth limitation (or something similar) could be retained for that portion of a plan's unfunded vested liabilities attributable to the pre-ERISA period provided that PBGC is granted authority to remove the availability of the 30 percent net worth limitation in the event the plan is not terminated for a legitimate business reason (i.e., a reason other than merely attempting to transfer liabilities to the insurance system). Heavy penalties should be imposed on employers who are found to have attempted a plan termination for a non-legitimate business reason as this type of action is tantamount to trying to collect fire insurance for arson. Essentially, the same principles could be applied to withdrawal liability under the multi-employer provisions provided the withdrawal involved affected less than a given percentage of the plan's total unfunded liabilities.

(3) As indicated, a per capita premium formula is not the most equitable way to finance termination insurance and such an approach becomes even more vulnerable if higher premiums are necessary. Since the original per capita premium assessments enacted by ERISA ($1 for single employer plans; 50 cents for multiemployer plans) were totally inadequate to begin with, recent and proposed increases by PBGC are probably well-justified. However, the time is ripe to consider whether adding a risk-related factor to the premium formula would result in a more appropriate method of building up PBGC insurance reserves.

The approach of predicating a premium on the difference between a plan's assets and its unfunded vested liabilities (or some variation thereof) no longer seems to me to be justified. Funding ratios may not have and frequently do not have a particular correlation to the health of the industry in which the plan is located. The risk of an employer terminating a pension plan in a distressed industry is obviously greater than that of an employer in a prosperous one. Also, besides being harder to administer, premiums based on funding ratios can result in sudden undesirable distortions due to such events as mergers or acquisitions. I suggest consideration of a permanent two-tier premium formula for both single and multiemployer plans based on a combination of a per capita assessment and an assessment based on an industry risk classification system. This means that the premiums for plans in troubled industries will be somewhat higher regardless of a plan's funding ratio at any particular point in time.

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[2] There is also a question of fairness with respect to liabilities created between the date of ERISA's enactment and the enactment of any legislation eliminating the 30 percent net worth limitation. Requiring employers to absorb liabilities for this period without regard to the 30 percent net worth limitation may be less onerous than for the pre-ERISA period.

In closing, I would like to commend the Chairman and Members of the Committee and the staff for their willingness to explore and consider fresh perspectives on these problems. Just like war is too important to be left to the generals, private pensions are too important to be left to the technicians, the bureaucrats and the various well-established interest groups that regularly skirmish on the subject.

Despite the advent of the I.R.A. era, it would be premature to put the defined benefit plan on the endangered species list. That evaluation would have to change, however, if a combination of burdensome government regulation coupled with continued adverse economic circumstances led employers to conclude that defined benefit plans were no longer practical. It is a source of some irony, at least to me, that many of the same voices that prior to ERISA criticized termination insurance as unnecessary because of the relatively small number of plan terminations then taking place, now criticize it as impractical because of the potential for some rather large scale terminations. Since it is doubtful that defined contribution plans or I.R.A.'s can ever completely and adequately provide the kind of retirement income security provided by a defined benefit plan, and since it is imperative that, to the maximum degree feasible, workers' pension rights in defined benefit plans be assured in case of plan termination, it is clearly a matter of priority for the Congress to readdress the subject of termination insurance in a manner that strikes a more effective balance between the need to safeguard the integrity of the insurance programs and the need to maintain the desirability of these plans from the companies' point of view.

The CHAIRMAN. Thank you, Mr. Gordon, for an excellent statement.

STATEMENT OF THOMAS WOODRUFF

Mr. WOODRUFF. Mr. Chairman, and members of the committee, I am pleased to appear today before you on this important subject. I have a written statement which I would like to submit for the record, and in part, because of Mike Gordon's excellent summary, I will skip over some of the background in my testimony.

Mr. Chairman, I personally have been involved in the problem of pension funding and underfunding since 1977 when I headed a Department of Labor study group on this subject that led to reforms in the reporting and disclosure of actuarial information to the General Revenue Service, and the Department of Labor.

I concluded then, as I do today, that we have a potentially disastrous problem facing us in the years ahead with serious underfunding of too many of our Nation's private pension plans.

This underfunding, coupled with the record number of business failures we are now witnessing throughout the economy, could lead in the future to the loss of billions of dollars of earned pension benefits by workers covered by private pension plans.

Reports published recently by Dun & Bradstreet and the Wall Street Journal have indicated that in the first 3 months of this year, 36 businesses filed for bankruptcy every hour of each business day, or at an annual rate of 75,000 businesses a year.

This, Mr. Chairman, would be a record number of business failures in any one year in our history.

The current premium and even the proposed new premium of $6 per capita may not be sufficient to take care of this record number of small and medium-sized business failures throughout the economy.

In addition, the failure of one major corporation such as Chrysler, might require a very significant increase in the levies of taxes on our private pension system.

It appears to me that we have a time bomb on our hands waiting to go off and we dc not know, because of inadequate reporting and disclosure, how big the explosion may be.

Today, Congress is preoccupied with the financial problems facing the social security system. I urge you and your committee not to neglect the funding and benefit guarantee problems that threatens the security of those participating in our private pension systems.

Mr. Chairman, as Mike Gordon pointed out when ERISA was passed, four major provisions were provided to insure the benefits security of our Nation's retirees. I would like to briefly review three areas in need of reform and then suggest some specific recommendations I would like to make to your committee.

The first area concerns the minimum funding standards under ERISA.

As Mike Gordon pointed out, the minimum funding standards under ERISA call for pension plans to pay annually for each year's current costs and then they spread payments for past service credits in any benefit improvements over a 30-year period.

The 30-year amortization is significant for two reasons. First, virtually all pension plans in the private sector are not indexed to inflation. Workers are dependent on ad hoc benefit improvements to maintain the real value of their pension benefits.

Nearly all of these ad hoc inflation adjustments will be paid for over a 30-year period. Second, as both workers and employees realize the inadequacy surrounding the social security system, they are seeking a greater role for private pension benefits.

Again, all of these benefit improvements will likely be paid for over a 30-year period into the future.

Even though all of this is considered legal and acceptable according to today's actuarial standard this process leads in my opinion to serious underfunding.

As I mentioned earlier, Mr. Chairman, beginning in 1977, the DOL task force that I headed suggested recommendations that led to new reporting and disclosure requirements for pension plans.

We called for changes that were implemented that called for a single actuarial cost method to be used for disclosure purposes, required disclosure of explicit actuarial assumptions on the form and required the reporting of new numbers, the present value of accrued benefits and the present value of vested benefits.

While we can now tell more on a more uniform basis, these figures have one major deficiency. They do not propose suggestions on future increases and salary-related plans.

The DOL task force, as well as the Standards Board in Stamford, Conn., recommended salary projections and salary-related benefit plans.

However, the actuarial community objected on the basis of increased administrative costs and the Department dropped that part of the proposal.

In addition, Mr. Chairman, while we are now getting better reporting to the Government on actuarial disclosure, virtually all pension-related research has been halted by the Department of Labor. Included in this research that has been halted is the computerization of the annual reports and the schedule B actuarial reports which discloses new data that I reported to you.

In the area of planned termination insurance, Mr. Chairman, I believe it is now time to move from the flat per capita system to some form of either risk-related or variable premium system like that suggested by Mr. Gordon.

I feel, though, that the complexities involved in a true risk-related premium are probably too serious to consider implementing such a plan in the near future.

However, I do believe it is possible today to introduce a variable premium system that would have two components as well. The first, a low per capita assessment on all pension plans that would be equal and then a variable component that would be a function of the newly disclosed unfunded vested benefits that are now reported under the schedule B actuarial report.

Some form of risk-related or variable premium must be instituted as PBGC premium levels rise in the future. Companies should be rewarded for funding their plans, not punished.

Mr. Chairman, we can safely predict today that premium levels will rise in the future. It is unrealistic to expect that we can truly insure pension benefits with per capita taxes of only several dollars per year.

Furthermore, if our economic climate continues to worsen, and certain major industries continue to decline due to overseas competition or other domestic problems, we may need to even rethink the whole concept of termination insurance.

In conclusion, I would like to make six points in need of reform and then suggest also agreement with some of the other things that my fellow panelists are suggesting today.

First, I think you and your committee should be commended on holding this hearing today, and I think you should make it a regular activity. As the economic climate of the country worsens, we need to carefully monitor the condition of our Nation's pension system.

Second, I believe we are in serious need of improving the minimum funding standards. In particular, I believe the amortization period for supplemental cost should be decreased to 20 and maybe even 15 years.

I would like to agree with the other panelists, particularly Mike Gordon and others who are following me, that the 30 percent net worth limitation on corporate liability should be changed and I believe it should be changed to either 100 percent of its net worth or corporate assets.

Third, I believe the reporting and disclosure requirements should be improved. In particular, salary projections should be added to the present value figures currently required to be disclosed in schedule B actuarial reports to the Internal Revenue Service and the Department of Labor.

Fourth, research funds should be restored to the Department of Labor and the Internal Revenue Service for data processing and pension related research.

Fifth, we should rethink the whole concept of planned termination insurance. At a minimum, we should implement a variable premium structure to eliminate some of the current inequities.

If the current economic climate continues to worsen and business failures continue to proceed at their current pace, we should then rethink the whole concept of termination insurance and rethink whether some form of government support may be necessary.

Sixth, and finally, at the risk of offending many of my friends in the actuarial profession, I would like to make one last recommendation.

That is, the Congress should consider the need for greater regulation of actuarial practices. Actuaries today are asked to perform an impossible task. While we can not rely on economists to forecast economic conditions reliably for more than one quarter of 1 year, we, every year, ask actuaries to forecast conditions 30 and 40 years into the future.

Their work is too important to the benefit and security of our Nation's elderly to be neglected by Congress.

That concludes my remarks, Mr. Chairman. Thank you for the opportunity to appear.

[The prepared statement of Mr. Woodruff follows:]

PREPARED STATEMENT OF PROF. THOMAS C. WOODRUFF

Mr. Chairman and members of the Committee, I am pleased to appear before you on this important subject today. I have been personally concerned with the problem of pension funding problems since 1977 when I led a Department of Labor task force to improve the reporting and disclosure of funding data in the actuarial reports (Schedule B of the form 5500 Annual Report) submitted to the Internal Revenue Service (IRS) and the Department of Labor (DOL).

The findings of my task force resulted in new reporting and disclosure requirements for actuarial information in the IRS and DOL Schedule B report and to new accounting standards for pension plans issued by the Financial Accounting Standards Board (FASB).

I concluded then as I do today that we have a potentially disastrous problem facing us in the years ahead with serious underfunding of too many of our nation's private pension plans. This underfunding, coupled with the record number of business failures that we are witnessing, could lead to the loss of billions of dollars of earned pension benefits by workers covered by private pension plans.

Reports published by Dunn & Bradstreet and the Wall Street Journal this week indicate that in the first three months of this year 36 businesses filed for bankruptcy every hour of each business day or at an annual rate of 74,676. This would be the largest number of failures in one year in American history. According to Dunn & Bradstreet business failures are running at 80 per 10,000 companies; approaching the Depression record of 100 per 10,000.

A continuation of this trend could easily bankrupt the entire pension guarantee system.

The recent indication by the Pension Benefit Guarantee Corporation (PBGC) that we may need to increase the $2.60 per capita premium for single employer plans to $6.00—a 130 percent increase—should be a sign that the benefit guarantee system is in trouble. Furthermore, according to a well-publicized internal PBGC staff memorandum, the $6.00 premium will not be sufficient to cover any large business failures such as the Chrysler Corporation. Special levies, the memo states, will be necessary should that occur. In addition even the $6.00 premium may not be sufficient to take care of the record number of small and medium sized business failures that we are experiencing. It appears that we have a timebomb on our hands waiting to go off—and, we do not know how large the explosion will be. Today, Congress is preoccupied with the financial problems facing the social security system. I urge you not to neglect the funding and benefit guarantee problems that threatens the benefit security of our nation's 35 million private pension plan participants. Today's hearing will hopefully mark the beginning of such a serious review process. Mr. Chairman, when the Employee Retirement Income Security Act (ERISA) was passed in 1974, Congress hoped that the benefit loss problems created by such events as the Studebaker collapse would be eliminated. The four major provisions of ERISA were designed to guarantee benefit security: minimum funding standards, fiduciary rules for pension trustees, reporting and disclosure requirements, and the pension plan temination insurance program. Three of these provisions—funding standards, reporting and disclosure, and termination insurance suffer potentially fatal deficiencies. The fourth, fiduciary standards, may be in need of some changes to address problems beyond the scope of today's hearings, but poses no serious threat to benefit security.

I will briefly review the three provisions in need of reform and suggest improvements that I believe are necessary.

FUNDING

The passage of ERISA led to substantial changes in the way pension plans are funded. ERISA calls for companies to finance defined benefit pension plans by paying "normal costs" each year and the amortization payment so-called "supplemental costs" or past service credits. Simply put, benefit pension plans must pay annually for each year's current costs but they may spread payments for past service credits and any benefit improvements over a 30 year period.

The 30-year amortization is significant for two reasons. First, virtually all private plans are not indexed to inflation. Workers are dependent on ad hoc benefit improvements to maintain the real value of their pension benefits. Nearly all of these ad hoc inflation adjustments will be paid for over a 30-year period. Second, as both workers and employers realize the inadequacy and the uncertainty surrounding the social security system, they are seeking a greater role for private pension benefits. Again, all of these benefit improvements are likely to be paid for over a 30-year period.

Why is this important? Take the example of a 35 year-old worker who plans to retire 30 years from now at the age of 65. We know today that at least part of the cost of every benefit improvement made in his plan between now and his retirement date (and beyond, if he/she is lucky) will be borne by his employer and future generations of workers after he retires. In other words, even though ERISA calls for private pensions to be "funded" ERISA still permits an element of intergenerational income transfer to exist, not unlike that which we find in social security.

Even though all of this is perfectly legal and acceptable by today's actuarial standards, this process leads, in my opinion, to serious underfunding. I believe this is particularly true in collectively-bargained plans of the flat benefit and unit benefit type.

What should be done? Given the uncertainties concerning inflation and business stability, it seems reasonable to consider a significantly shorter amortization period for past service costs and benefit improvements. This Committee should ask the Department of Labor and the Pension Benefit Guarantee Corporation to study the impact of reducing the standards to 20 and maybe even 15 years.

REPORTING AND DISCLOSURE

As I mentioned earlier, beginning in 1977 I headed a DOL task force to review actuarial reporting and disclosure. Our work led to final regulations in late 1978 applicable to the 1979 Schedule B actuarial reports calling for improved reporting of actuarial and accounting information. The changes (1) instituted the use of a single actuarial cost method for disclosure purposes (2) required disclosure of "explicit" actuarial assumptions and (3) required the reporting of new numbers: the present value of accrued benefits, present value of vested benefits for retirees, present value of vested benefits for actives and terminated employees, and the current value of plan assets.

These figures are a major improvement over what was previously available. For the first time it is now possible to compare these figures from plan to plan and company with the knowledge that consistent methods have been employed. Actuaries are still free to use a variety of assumptions that certainly complicates any analysis, but at least we now can look at the major assumptions displayed individually and "explicitly."

Following the implementation of these new rules, the Financial Accounting Standards Board (FASB) adopted the same standards for pension plans and an interim basis—for footnotes to corporate financial statements.

While we now can tell more, these figures have one major deficiency: they do not disclose projections on future salary increases in salary-related plans or a reasonable estimate of future benefit improvements for unit or flat benefit plans. The DOL task force as well as FASB had recommended salary projections in salary-related benefit plans. However, the actuarial community objected on the basis of increased administrative costs and the Department dropped that part of the proposal.

It seems clear today that not having projections on future salary increases is a mistake and I urge this Committee to request that the DOL consider the inclusion of these figures in future reporting requirements.

In addition another tragedy has occured in the reporting and disclosure area. Due to budget cutbacks, virtually all pension-related research has been halted in the Department of Labor. Included in these cutbacks is computerization of the annual reports and the Schedule B actuarial reports. So now we have tens of thousands of forms being filed with the IRS with virtually no utilization of this information. I urge this Committee to call for the restoration of funds to the IRS and the Pension and Welfare Benefit Programs of the DOL to enable them to process and analyze this important data. The expenditure of a few hundred thousand dollars today might just save retirees billions of dollars in the future.

PLAN TERMINATION INSURANCE

The plan termination insurance program administered by the Pension Benefit Guarantee Corporation (PBGC) is made up of two risk pools (one comprised of multi employer plans and one of single employer plans) with the benefit guarantees financed by per capita "assessments," "taxes," or "contributions" on the individual plans. Under this system, the well-funded plans subsidize the plans that terminate and are underfunded.

Since its inception the PBGC has explored the possibility of developing a so-called "risk-related" premium to eliminate the obvious inequities that exist in the current system. These efforts have failed to produce such a premium structure due to the complexities of the problem, the inadequacy of available data to determine risk, and the judgement that with premiums at past or even current levels the inequities were not too serious.

The complexities certainly are there. Not only does one need to assess the funding status of the plan, but one needs to analyze the probability of the business failure of the plan sponsor—the employer.

We do, however, now have better data on the pension plan available due to the 1978 reforms instituted by the DOL. It is now possible to develop a variable premium that would have two components: (1) a low per capita component and (2) a variable component that would be a function of unfunded vested benefits (currently disclosed on Schedule B).

Some form of risk-related or variable premium must be instituted as PBGC premium levels rise in the future. Companies should be rewarded for funding their plans, not punished. It is time once again to develop some solid proposals for a variable premium and I urge this Committee to monitor PBGC's efforts in this area.

Premium levels will rise in the future. It is unrealistic to expect that we can truly insure pension benefits with per capita taxes of only several dollars a year. If our economic climate continues to worsen and certain major industries continue to decline due to overseas competition we may need to even rethink the whole concept of termination insurance. I urge this Committee to continue the hearings process on this subject.

CONCLUSION

In conclusion, Mr. Chairman, I would like to praise you and this Committee for holding these hearings. We mustn't let the complexity of the pension funding problem lull us into inattention. While we have a potentially disastrous problem facing us in the years ahead, I believe that a number of actions can be taken by Congress to minimize the problems in the future. These actions are:

(1) Continue to monitor the problem by holding hearings regularly.

(2) Improve funding standards. In particular, shorten the amortization period for supplemental costs to 20 perhaps, 15 years.

(3) Improve reporting and disclosure requirements. Add salary projections to the present value figures currently required in the Schedule B actuarial report to IRS and DOL.

(4) Restore research funds. Restore funds cut from DOL and IRS budgets for data processing and pension-related research.

(5) Rethink plan termination insurance programs. (a) Develop and implement a variable premium structure to eliminate some of the current inequities. Utilize Schedule B disclosure data to develop the variable premium. (b) If our economic climate continues to worsen and business failures continue to occur a near-depression

levels, rethink the concept of termination altogether. Can we really have true benefit guarantees without government support?

At the risk of offending many of my friends in the actuarial profession I would like to make one last recommendation. That recommendation is that Congress should consider the need for greater regulation of actuarial standards used to fund defined benefit pension plans.

Actuaries today are asked to perform an impossible task. While we cannot rely on economists to forecast economic conditions reliably for more than one quarter of one year, we ask actuaries to forecast conditions thirty and forty years into the future.

In so doing, actuaries are free under current law to use whatever assumptions they determine to be "reasonable in the aggregate." Unfortunately, by the time we determine that an actuary didn't apply good reason to his/her calculations, it may be too late.

Public and private plan assets now exceed $800 billion and each year this number is increased by about $40 billion in new contributions. We are talking about significant amounts of the nation's annual savings.

I urge this Committee and Congress to look at the problem of actuarial funding methods carefully and to consider the possibility of either establishing stricter federal standards or urging the actuarial profession to develop more uniform standards for its members.

That concludes my remarks, Mr. Chairman. Thank you for the opportunity to appear before your Committee.

The CHAIRMAN. Thank you very much, Mr. Woodruff, for an excellent statement.

STATEMENT OF WILLIAM PRIEST

Mr. PRIEST. My name is William Priest, vice president and director of BEA Associates, an investment counseling firm located in New York City. With me is my associate, Mr. Patrick Regan, a vice president and director of pension planning.

This statement is a joint one and reflects an argument put forth 6 years ago in our book, "The Financial Reality of Pension Funding Under ERISA." Many of the questions debated today can be addressed by answering two questions, whose money is at stake and whose money should be at stake.

The framework described herein will answer these questions. Prior to ERISA and contrary to conventional wisdom, it was not the plan sponsors money at stake. The company had the option of paying the pension promised in full or turning over the entire fund to the employees whichever was less.

In practice, most corporations kept their promises but this option existed nevertheless and in some cases was exercised most notably by the Studebaker Co.

The goal of ERISA was to prevent these abuses and place the burden of funding upon the promisor. It failed to do so in two important respects. Section 4023 and the 30 percent rule.

Section 4023 has been eliminated or expunged from the act already.

Important to our exposition is the conceptual of understanding of how the financial burden of ERISA falls and who bears it. It can be best analyzed conceptually in a series of several balance sheets.

With your indulgence, I would briefly like to refer to the figure 1 and figure 2 of our handout.

Section 1 of that handout shows the balance sheet in market value terms. To calculate these, we obtained the market value for the stockholders equity by multiplying the number of shares outstanding by the value of the stock. We also obtain the market value for the long-term liabilities.

Current liabilities may be taken at face value. In effect, this gives you half of the information you need. We can subtract the current asset section from this total and that gives you the implied worth of all other assets.

Now, section 2 reflects the inclusion of the pension assets and the pension liabilities, again, in market value terms—I think it is important that people deal in market value terms, not book value.

The corporate pension liability is an asset to the employee for it represents his claim on the employer. Since pension assets at times do not always equal the present value of their liability, the difference would normally be expected to come out of the market value of the common stock.

It did not, however, because of the existence of an option held by the corporation. This option, prior to ERISA, allowed the company to pay the employee what was owned to him or turn over to the employee the assets of the fund, whichever was less.

You can construe this as an option or—a "pension put". This "put" was an asset to the employer and a liability to the employee, for it represented a risk to the employee that his claim might not be paid in full when due.

Section 3 of figure 1 reflects this unknown value of the "put" and represents the difference between the pension assets at market value and the present value of the pension liability.

Enter ERISA. The law was designed to prevent the exercise of this option, most notably put forth by the Studebaker case, and it was an attempt to place the risk of inadequate funding upon the promissories, the planned sponsor. This is where it belonged.

The wage earner had traded for future compensation and the employee had the right to expect payment. Now, section 4 introduces the balance sheet of the PBGC, in Figure 1. Since the Pension Benefit Guaranty Corp. guarantees the employee will be paid up to a maximum amount, what had been the employee asset becomes a liability of the PBGC and as we know, the PBGC's principal assets are the head taxes collected from the plan sponsors, plus a claim on the sponsor's net worth equal to 30 percent.

Indeed, if the PBGC cannot act until net worth is zero, then 30 percent of zero is zero.

Now, this argument that the employee owns American industry is inappropriate. To be an owner, you must have equity at stake. You must bear risk. Under ERISA, the employee is off the hook for the PBGC guarantees he will get paid.

Figure 2 shows the general financial relationship that exists under ERISA and who does bear the financial risk. The employee now is off the hook. The risk is a trade-off between the corporation and the PBGC.

Originally this "put" was preserved, as I said, through section 4023, and the 30-percent rule. We have seen where the former was eliminated. But several insights fall out of this analysis. The PBGC is in effect writing market risk insurance rather than specific risk. Unlike an insurance company, where it writes fire insurance, each fire is a random occurrence independent of one another.

The claims that were made upon the PBGC will occur at a time when there is a great deal of systematic risk, in other words, a serious recessionary environment. The claims will all come due at the same time.

Hence, rather than random occurrences, you will have a substantial claim as is being made right now. It is unfair to tax the well-funded plans to pay for the poorly funded plans in that it is another form of income transfer process and we would recommend keeping the head tax at a nominal level and raise the PBGC claim to 100 percent and allow it to act in the same capacity as FDIC with regard to the Nation's banking system.

If the employee is simply a debt claimant, and bears no risk of underfunding, the converse is also true. He should not receive overfunded amounts in the plan. They belong to the shareholders. Hence, the termination decision by a company such as A&P is OK, provided the employee is getting what he is due and any excess amount belongs to the shareholders.

Essentially, this argument states that when you walk through the question of "whose money is at stake," the answer becomes obvious. At one time prior to ERISA it was the employee. Under the ERISA, it is a trade off between the PBGC and the corporation. The obligation rightfully belongs upon the corporation.

How do you get there? You get there by making the 30-percent rule a 100-percent rule.

My associate, with his representation on the CELI panel and the FASB panel has additional comments with respect to specific occurrences.

[The prepared statement of Mr. Priest and Mr. Regan follows:]

PREPARED STATEMENT OF WILLIAM W. PRIEST, JR., AND PATRICK J. REGAN

Thank you, Mr. Chairman. My name is William W. Priest, Jr. I am a Vice President and Director of BEA Associates, Inc., an investment counseling firm located in New York City. With me is my associate, Mr. Patrick Regan, a Vice President and Director of Pension Planning. This statement is a joint one and reflects an argument put forth six years ago in our book, The Financial Reality of Pension Funding Under ERISA.

It is a pleasure to appear before this august body to exchange views pertaining to the private retirement system. In this statement, we would like to present a framework for examining the financial issues of pension funding. Within this framework, we can define the bankruptcy risk and quantify the potential threat to the solvency of the Pension Benefit Guaranty Corporation. Many of the questions debated today can be addressed by answering two questions--whose money is at stake and whose money should be at stake? The framework described herein will answer these questions.

Prior to ERISA, and contrary to conventional wisdom, it was not the plan sponsor's money at stake. The company had the option of paying the pension promise in full or turning over the entire fund to the employees, whichever was less. In practice, most corporations kept their promises, but the option always existed and was exercised in some cases, most notably by the Studebaker Company. In effect Studebaker said, "Fellas, the fund is inadequate to meet our promises to you, so rather than come up with higher corporate contributions by selling assets, expanding liabilities, or cutting dividends, we will turn over the entire pension fund to you, inadequate as it may be."

This financial relationship between the employer and the employee can best be analyzed in the context of several balance sheets.[1] Consider the balance sheets that appear in Figure I of the handout. All items in the balance sheet are market values, not book values.*

Section 1 shows the corporate balance sheet in market value terms. To calculate values, we obtain the present market values for the stockholders' equity section and long-term liabilities, to which is added the current liabilities. From this sum we deduct current assets, which gives us the implied market value of the fixed assets. Hence our balance sheet balances.

Section 2 reflects the inclusion of the pension assets and the pension liabilities, again in market value terms. The corporate pension liability is an asset to the employee, for it represents his claim on the employer. Since pension assets at times do not equal the present value of the liability, this difference would be expected to come out of the market value of the corporate equity.

It did not, however, because of the existence of an option held by the corporation. This option, prior to ERISA, allowed the company to pay the employee the sum owed or turn over to the employee the assets in the pension fund. We call this option the "pension put." This "put" was an asset to the employer and a liability to the employee, for it represented a risk to the employee that his claim might not be paid in full when due.

The only relevant value to be considered is market value because this value impounds everything known about the firm including all past market values. Any asset is worth only what a willing buyer will pay for it and this will be market value.

Additional support for the use of market values can be made by considering the position of a lender. His interest lies in ensuring that the market value of his collateral exceeds the face amount of his loan; otherwise, the lender is sharing the equity risk as well, without exposure to the rewards of the equity position. No lender will intentionally lend funds where the market value of the collateral is below the face amount of the loan. This was a major problem for Braniff, when its bankers became concerned over the falling value of its fleet of aircraft.

Section 3 reflects the unknown value of the "put" and represent the difference between the pension assets at market value and the present value of the pension liability.

Enter ERISA. This law was designed to prevent the abuse (among others) demonstrated by the Studebaker case. It was an attempt to place the risk of inadequate funding upon the promisor, the plan sponsor. This is where it belonged. Current wages had been traded for future compensation and the employee had the right to expect payment. ERISA failed to achieve this goal, because the pension put was allowed to continue--only this time, the "put" was to a new government body, the PBGC.

Section 4 of Figure I introduces the balance sheet of the PBGC. Since the PBGC guarantees that the employee will get paid, up to a maximum amount, what had been the employee asset becomes a liability of the PBGC. The PBGC's principal assets will be the head taxes collected from plan sponsors plus a claim on the sponsors' net worth equal to a maximum of 30%. (But if the net worth is zero, then this claim is also worthless.) The employee is simply a debt claimant. The argument that he owns American industry is utter nonsense. To be an owner you must have equity, you must bear risk. He has no risk for he is a debtor.

Figure II shows the general financial relationships that exist under ERISA. Who bears the financial risk now is between the corporation and the PBGC. No risk is now borne by the employee.

Originally, the pension "put" was preserved through Section 4023, contingent employer liability insurance, and the 30% rule. The Multi-employer Act of 1980 expunged Section 4023; one more step remains. The

30% rule should become the 100% rule. By this act, the employer is responsible for the promises made and the integrity of the private system can be maintained.

Several insights fall out of this analysis. The PBGC is, in effect, writing "market risk" versus "specific risk" insurance. That is, when firms exercise their pension "put," it will occur in difficult economic circumstances that affect almost all firms. Hence, rather than random occurrences, they will tend to come about at the same time and several claims will be placed upon the PBGC simultaneously.

It is unfair to tax the well-funded plans to pay for the poorly funded plans. This is simply another income transfer process that circumvents efficient resource allocations. The head tax should remain at a nominal level and the PBGC claim should be raised to 100%.

If the employee is simply a debt claimant, he bears no risk of underfunding. The converse is true also; he should not receive overfunded amounts in the plan. They belong to the shareholders. Hence, the termination decision by A & P is all right--the employee will receive his due, the shareholder receives the excess.

This framework allows for analysis of the financial implications of ERISA and resolution of key issues. Regarding those key issues, we have been asked to address the following questions:

1) What is the current funding status of the private pension system and how many plans are seriously underfunded?

According to the SEC's latest survey, private non-insured pension funds held nearly $300 billion in assets at the end of 1980.[2] This was double the figure of 1975 and nearly triple the figure of 1970. Thus, through a combination of good investment results and larger contributions, sponsors have kept pension assets growing at a much faster rate than inflation.

Pension liabilities are tied to inflation, as most plans are of the final-pay type, with retirement benefits based on the final few years of an individual's earnings. A September 1981 survey of 100 major corporations by Business Week showed pension assets of $134 billion covering vested benefits of $123 billion.[3]

The 1981 BEA Pension Survey, which is summarized in the handout material, analyzed 40 major corporations that account for 25% of the pension assets and one-sixth of the labor force covered by ERISA.[4] The companies in our survey held $74 billion in pension assets and owed total vested benefits of $72 billion. Thus, in the aggregate, pension assets seem adequate to cover vested benefits.

The PBGC is concerned with situations where the unfunded guaranteed liabilities (which tend to be 85-90% of the vested benefits) are in excess of 30% of the sponsor's net worth. The computer screens of the 1,000 or 2,000 public corporations on which data is available have always shown that 3-4% have unfunded vested benefits in excess of 30% of net worth. The use of higher interest rate assumptions as well as the robust stock market of 1980 suggest that the proportion of such "problem" plans today is somewhat less, perhaps 2%.

2) How can we identify these "problem" plans?

Moody's, the bond rating agency, has incorporated pension costs and liabilities into its credit ratings.[5] It chose to treat unfunded pension obligations as long-term debt and to focus on the firm's ability to service both the pension contributions and its debt. Not surprisingly, Moody's found that the companies with pension problems were generally the companies with other financial problems--poor profitability and highly leveraged balance sheets--so that no downward revisions were needed in their credit ratings. As our own survey shows, the large unfunded obligations tend to occur in mature cyclical industries, such as autos, steel and tire and rubber. As shown by Figure III in the handout material, only 16 out of 40 companies in our sample reported any unfunded vested benefits in 1980 and, in most cases, the unfunded obligation was equal to less than 25% of the value of the pension fund.[6] In 1980 alone, the median increase in pension assets for the sample companies was 25%, suggesting that most plans could be fully funded if the stock and bond markets had a robust year.

A "problem" company would be one in which the unfunded vested liability was high relative to pension assets (e.g. over 100%) and to corporate net worth (e.g. over 30%) and in which the net worth is shrinking, because of continuing deficits.

3) What is the risk exposure of the PBGC with respect to these "problem" plans?

Bankruptcies are running at a level not seen since the 1930's and the PBGC may have to step in to guarantee sizeable amounts of pension benefits. Pensions and Investment Age magazine referred to one study which concluded that if 86 financially troubled companies that are on the banks' "problem loan" lists were to terminate their pension plans, the total unfunded liability for the PBGC would be $4 billion.[7] This probably overstates the case, as most plans are using interest rate assumptions of 6% to 9%, and much higher rates could be obtained in today's marketplace, which would reduce the present value of the obligations. For example, Braniff owes

$279 million in vested benefits, using a 7% assumption, but has only $130 million in pension assets. But the PBGC has estimated the shortfall at a maximum of $70 million, using realistic assumptions, not $149 million.

Also, not every bankruptcy would draw from the PBGC's coffers. A M International has filed for bankruptcy, but listed $142 million in pension assets to cover $122 million in vested benefits, using a conservative 7% assumption. Similarly, Wickes Companies, a major retailer, has filed for bankruptcy, but listed $92 million in pension assets to cover $107 million in vested benefits, using a conservative 7% assumption. Using a higher figure, the pension assets should cover the benefits.

Such examples suggest to us that the $4 billion risk for the PBGC is too high a figure. The PBGC's actuarial liability is estimated at $715 million, and the corporation is seeking to raise employee premiums from $2.60 to $6.00 per employee per year.[8] While this would temporarily make the PBGC actuarially sound, it would encourage the well-funded plans to switch from defined benefit to defined contribution, thereby withdrawing from the PBGC pool. We think that it makes more sense to remove the "put option" that weak, underfunded plans have on the PBGC by removing the 30% of net worth limit in the cases of voluntary termination. The PBGC should be able to recover assets up to 100% of net worth. In addition, it should have the power of an FDIC to step in, initiate an involuntary termination and protect itself and plan beneficiaries while a sponsor still has some net worth. While it currently has this power, it has not been used. Finally, the PBGC should continue to offer special "hardship" arrangements so that troubled companies will continue funding their plans and not be tempted by the voluntary termination.

What if the PBGC is overwhelmed by claims and terminations? Should Congress let the private pension system disappear by penalizing the strong sponsors to bail out the few weak ones? Given that 28 million people are currently protected by the PBGC, Congress could have the Treasury guarantee the PBGC with an emergency fund, instead of boosting premiums to too high a level. The funds might not even be needed, since the retirement benefits would be paid out over many years, but at least the system would be actuarially sound.

FOOTNOTES

1. Jack L. Treynor, Patrick J. Regan and William W. Priest, Jr., The Financial Reality of Pension Funding Under ERISA, Dow Jones-Irwin, 1976.
2. Securities and Exchange Commission, "Assets of Private Non-Insured Pension Funds - 1980," SEC News (May 15, 1981).
3. "Pension Liabilities: Improvement is Illusory," Business Week (September 14, 1981) pp. 114-118.
4. The 1981 BEA Pension Survey, published by BEA Associates, Inc. The survey findings are summarized in: Patrick J. Regan, "Reasons for the Improving Pension Figures," Financial Analysts Journal (March 1982) pp. 14-15.
5. "ERISA - A Bond Rater's View," Moody's Bond Survey, February 28, 1978. This was summarized in: Patrick J. Regan, "Credit Ratings and Pension Costs," Financial Analysts Journal (March 1979) p. 6.
6. Taken from The 1981 BEA Pension Survey, based on 1980 and fiscal 1981 data.
7. "Pressing Problems of the PBGC," Pensions and Investment Age (May 10, 1982) p. 10.
8. "Rise Urged in Pension Premiums," The New York Times (May 20, 1982) p. D-2.

FIGURE I

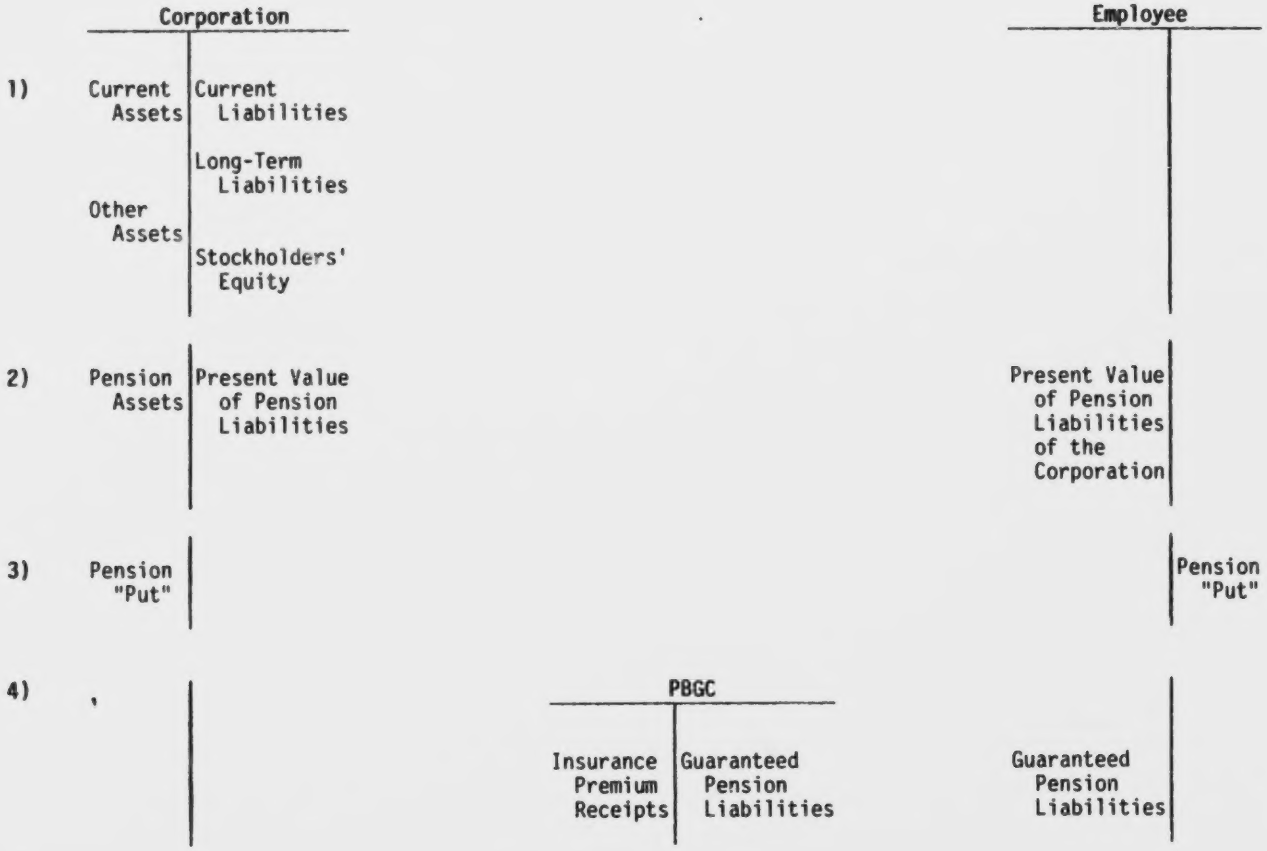
Corporation
Employee
1)
Current Assets
Current Liabilities
Long-Term Liabilities
Other Assets
Stockholders' Equity
2)
Pension Assets
Present Value of Pension Liabilities
Present Value of Pension Liabilities of the Corporation
3)
Pension "Put"
Pension "Put"
4)
PBGC
Insurance Premium Receipts
Guaranteed Pension Liabilities
Guaranteed Pension Liabilities

FIGURE II

General Financial Relationships under ERISA

EMPLOYER

Corporate Assets	Corporate Liabilities
Pension Assets	Gross Pension Liabilities
Pension Put	Employer Equity

PBGC

Receipts from Insurance Premiums	Guaranteed Pension Liabilities
Gross Pension Liabilities	Pension Put
	PBGC equity, if any

BENEFICIARY

Guaranteed Pension Liabilities	

1. All entries are valued at market except the pension put – the value of which is based on option theory.
2. Both employer equity and PBGC equity are derived figures.
3. Because of the 30% rule, the PBGC asset, "Gross Pension Liabilities" will not quite equal the employer liability, "Gross Pension Liabilities"; similarly, the PBGC liability, "pension put," is somewhat smaller than the employer asset, "pension put," for the employee still bears a small pension put to the extent the employee has unfunded vested pension benefits that are not yet guaranteed.

FIGURE III

UNFUNDED VESTED BENEFITS RELATIVE TO PENSION ASSETS AND NET WORTH
(based on the 16 sample companies with unfunded vested benefits;
dollar figures in millions)

Company	Vested Benefits	Pension Assets	Net Worth	UVB as % of Pens. Assets	UVB as % of Net Worth
Chrysler	$3,022.5	$1,747.2	$ 459.2	73.0%	277.7%
Uniroyal	771.0	262.0	494.2	194.3	103.0
American Motors	464.0	238.0	434.2	95.0	52.0
Western Union	282.7	108.9	612.9	159.4	28.3
General Motors	17,438.5	13,353.8	17,814.6	30.6	22.9
B.F. Goodrich	565.5	380.9	947.8	48.4	19.5
Westinghouse	2,478.0	2,020.5	2,529.9	22.6	18.1
Bethlehem Steel	2,373.0	1,952.8	2,622.0	21.5	16.0
Republic Steel	1,124.0	901.0	1,507.8	24.8	14.8
Caterpillar Tractor	1,812.8	1,428.4	3,432.0	26.9	11.2
Borden	270.2	196.5	1,234.9	37.5	6.0
Honeywell	683.4	587.2	1,904.2	16.4	5.1
Armco	926.7	832.6	2,053.2	11.3	4.6
Sears	1,178.3	945.0	7,688.8	24.7	3.0
Warner Lambert	464.0	436.5	1,487.3	6.3	1.9
Woolworth	292.0	274.0	1,407.0	6.6	1.3

Source: The 1981 BEA Pension Survey. Based on data from 1980 and fiscal 1981 annual and 10-K reports.

Pension Fund Perspective

Patrick J. Regan
V.P., BEA Associates, Inc.

Reasons For The Improving Pension Figures

What with guest columnists and a commentary on the investment implications of social and political trends, we have neglected to mention the results of last year's pension survey. Each year, BEA Associates, Inc., updates a 40-company sample to obtain current pension figures for a cross section of American industry. The sample companies represent the four largest companies in 10 major industries, accounting for approximately 15 per cent of the employees affected by ERISA and 25 per cent of private pension assets. Table One summarizes the findings of the latest survey.

Table One Relative Growth of Pension Costs and Liabilities

	1973	*1974*	*1975*	*1976*	*1977*	*1978*	*1979*	*1980*
Growth of Pension Costs	14.5%	19.5%	14.7%	20.5%	8.5%	14.0%	11.0%	9.6%
Pension Costs as Percentage of Payroll	NA	6.5%	6.7%	6.8%	6.7%	7.0%	6.7%	6.5%
Pretax Profits Per Dollar of Pension Contributions	$7.00	$5.45	$4.41	$5.45	$4.88	$4.68	$4.65	$4.44
Vested Benefits as Percentage of Pension Assets	NA	129.0%	117.0%	124.5%	128.0%	122.1%	119.0%	91.7%

Source: 1981 BEA Pension Survey. Based on median figures from a sample of 40 major corporations.

By every measure—growth of pension costs, costs relative to payroll and pretax profits, pension liabilities relative to assets and corporate net worth—the figures were the best in years. What caused this remarkable improvement? Was the hefty stock market gain of 30 per cent plus sufficient to cover the unfunded liabilities? Or did the present value of the liabilities shrink simply because the Financial Accounting Standards Board (FASB) allowed higher interest assumptions to be used in the calculation of the disclosure data than were used in the computation of the actuarial data? How do the disclosure figures differ from the funding figures?

Growth of Pension Costs

Table One shows how pension costs and liabilities have grown since 1973. Pension costs grew at a consistent 15 to 20 per cent a year between 1973 and 1976, before slowing to an 8.5 per cent growth rate in 1977, 14 per cent in 1978, 11 per cent in 1979 and a modest 9.6 per cent in 1980. Other than 1977, the 1980 figure was the lowest of the decade.

The distribution was also the best in 10 years. In a typical year, one-tenth of the sample companies experience an increase of 40 per cent or more in pension costs and one-quarter post a gain of at least 25 per cent. In 1980, only one company—or 2.5 per cent of the sample—was in the latter category. Even more impressive, more than a quarter of the companies experienced declines in pension costs in 1980, up from 7.5 per cent in 1979 and 2.5 per cent in 1978.

Pension costs as a percentage of payroll continued to fall, from a peak of 7.0 per cent in 1978 to 6.7 per cent in 1979 to 6.5 per cent in 1980. The pattern of the prior two years reversed itself, though, as pension costs as a percentage of payroll rose for heavy industry (autos, some steel, tire and rubber) but held steady or fell for the drug and food companies. Perhaps the reduced level of employment accounted for the former, as pension costs had to be covered by fewer active workers and a smaller payroll. Also, the drug companies are multinational, and pension costs for foreign employees are generally less than for U.S. employees. Our figures may be distorted, because the payroll figures disclosed in annual and 10-K reports (and only 25 of the 40 firms chose to disclose this figure) include all employees, part-time as well as full-time, foreign as well as domestic. By contrast, the actuary has access to the "covered" payroll figure, which relates only to those employees covered by the pension plan. Pension costs as a percentage of covered payroll are typically 11 to 12 per cent and should not be confused with the figures in Table One.

The only negative note for 1980 was that the pension coverage ratio continued to deteriorate for the fourth consecutive year. Table One shows that rising pension contributions have been cutting into pretax profits. In 1973, the sample companies reported $7.00 of pretax profits for every dollar they contributed to retirement funds. This fell to $5.45 in 1974, hit a low of $4.41 in 1975 on recession earnings, recovered to $5.45 in 1976 and then began to tumble, hitting $4.44 in 1980. For eight companies, or one-fifth of the sample, pension costs exceeded pretax profits. The four auto companies reported deficits, as did Firestone. Bethlehem Steel, Lockheed and Uniroyal posted modest pretax profits after making pension contributions that were several times as large.

Unfunded Liabilities

Unfunded pension liabilities began to improve in 1978, and the trend accelerated in 1979 and 1980. For prior years, we related unfunded vested benefits to pension assets; in 1980 we were able to compare the present value of total vested benefits to the market value of pension assets. This is because the FASB, in Statement No. 36, required disclosure of the component parts instead of the net figure unfunded vested benefits. The new data are more relevant; a liability for unfunded vested benefits of, say, $10 million is much less worrisome if the pension fund has $100 million in assets than if it has only one million.

As shown by Table One, the median company in the sample had vested benefits equal to 91.7 per cent of pension assets, meaning that the typical company was fully funded on vested benefits at the end of 1980. The figures for prior years are not really comparable, since, as noted, we formerly related unfunded vested benefits to pension assets. Only 18 of the sample companies revealed pension assets for both 1979 and 1980, but for that group the median increase in pension assets was over 25 per cent. The typical pension fund had almost 60 per cent of its assets in stocks, and the stock market, as measured by the S&P 500, rose 32.6 per cent in 1980. Thus pension contributions plus portfolio appreciation accounted for the 25 per cent increase in fund assets.

A more interesting question involves the change in vested benefits. For the 18 companies that revealed vested benefits for 1979 and 1980, the median increase was 10.1 per cent. But FASB Statement No. 36 allowed companies to use a different interest rate assumption for disclosure purposes than for funding purposes. For example, Western Union uses a six per cent rate in determining its pension contribution, but for its 1980 annual report it opted to use an 8.1 per cent discount rate because that is the equivalent of the rate used by the Pension Benefit Guaranty Corporation in calculating annuity values.

Similarly, J.C. Penney and Republic Steel use six per cent for funding purposes, but chose to use 8.5 per cent and nine per cent, respectively, for disclosure purposes in 1980. The three-point spread was not that unusual, as Bethlehem Steel used a seven per cent rate for funding and a 10 per cent rate for disclosure purposes, while the figures at Firestone were 7.5 per cent and 10.7 per cent. It's hard to say what the increase in vested benefits would have been if the rates used were unchanged from the previous year; Pfizer did note that vested benefits would have been up 13.1 per cent under the six per cent discount rate it used in 1979, but its vested benefits were down 13.9 per cent under the 8.5 per cent rate used for disclosure purposes.

Table Two Changes in Vested Benefits and Interest Rate Assumptions

Company	*Changes in Vested Benefits (1980)*	*Interest Rate Assumptions* 1980	1979	Change
Pfizer	−13.9%	8.5%	6.0%	+2.5
Monsanto	−10.2	7.5	7.0	+0.5
Dart & Kraft	−6.3	8-8.5	5-7.5	+1.0
General Motors	−4.0	8.25	7.0	+1.25
Union Carbide	−0.6	8.0	7.0	+1.0
Du Pont	+1.9	8.6	7.9	+0.7
Uniroyal	+2.5	8.3	7.2	+1.1
Ford	+8.8	7.0	7.0	same
Eastman Kodak	+9.1	6.25	6.25	same
General Electric	+11.1	6.0	6.0	same
Dow Chemical	+13.3	6.5	6.5	same
U.S. Steel	+14.6	10.0	9.0	+1.0
McDermott	+15.4	8.0	8.0	same
Sperry	+17.5	8.0	8.0	same
Warner Lambert	+19.0	7.5	6.5	+1.0
IBM	+24.1	4.75	4.75	same
Xerox	+26.1	7.0	7.0	same
Honeywell	+32.1	7.0	7.0	same

Source: 1981 BEA Pension Survey, based on figures disclosed in 1980 or fiscal 1981 annual and 10-K reports.

The relation between the change in vested benefits and the change in interest rate assumptions is shown in Table Two. The 18 companies that disclosed the information are ranked by the percentage change in vested benefits. For the group as a whole, the median growth of vested benefits for 1980 was 10.1 per cent. However, for the nine companies that used a higher interest assumption than they had the previous year, vested benefits actually declined 0.6 per cent, while they rose 15.4 per cent for the nine companies that used the same rate in both years.

Also of interest, pension assets for the former group increased 22.1 per cent in 1980 whereas the pension assets of the latter group grew 28.3 per cent. Thus it appears that the companies that raised their interest assumptions and reduced the present value of their vested benefits were under more pressure on the asset side than those that opted to use the same assumption they had used in the previous year.

There was one final curiosity. We might expect companies with the highest interest rate assumptions to register the best portfolio performance. While year to year asset data were only available for half the sample, the 10 companies with the highest interest rate assumptions—ranging from 8.5 to 10.7 per cent—registered pension asset gains of 22.6 per cent, whereas the 10 companies with the lowest assumptions—ranging from 4.75 to 6.5 per cent—posted a median increase of 31.8 per cent. Companies in the former group were in the mature industries, where the ratio of benefits paid relative to corporate contributions is high, so that net contributions are low. Thus it could be that they experienced excellent investment returns (justifying the use of higher interest assumptions), but that a low level of net contributions resulted in modest growth of the total fund. On the other hand, they may be using the higher asusmptions because they are under pressure to hold down costs and vested benefits.

We have no figures this year on unfunded past service costs. FASB Statement No. 36 deals only with accrued benefits, whereas for funding purposes most companies use one of the projected benefit methods, which require a forecast of experted wage and salary increases.

Conclusion

In sum, pension cost and liability figures continued to improve in 1980. A robust stock market was a major factor, but just as important for some companies were the provisions of FASB Statement No. 36 that recognized only accrued benefits and allowed the use of higher interest rate assumptions for disclosure purposes. ■

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Mr. REGAN. I am Patrick Regan. My name was inadvertantly left off the list. Bill and I manage pension portfolios and in addition, I served as the financial analyst's federation representative on the PBGC Contingent Employer Liability Insurance—CELT—Panel, 1977-79. We drafted a report to Congress suggesting that section 4023 be expunged from the law, which was done with the Multiemployer Act of 1980.

You cannot have an insurance system where corporations or plan sponsors have an incentive to terminate plans and dump the pension liabilities on the PBGC. The first step was removal of section 4023.

That has been done.

The second step, I think, is to increase the PBGC claim from 30 percent of net worth to 100 percent, such that the corporation's assets are what are backing the pension liabilities.

I am also on the financing accounting standard board's pension task force, and we have had to tackle the problem which Professor Woodruff mentioned, of disclosure and measurement of the pension liabilities.

Much more information is available than people realize. Some of the credit rating agencies such as Moody's and Standard and Poor's have had to come to grips with this because they are putting out credit ratings on bonds.

They have had to investigate how well funded is the system.

I have tried to address the questions that you asked me about the system in general, specific problems, and how we can identify them.

The first question is how well-funded is the system in general? It is generally well funded. Private, noninsured pension funds had approximately $300 billion as of the end of 1980 to back up whatever pension liabilities they have.

Now, we haven't a handle on the magnitude of the liabilities. I think everyone is familiar with that. It depends on the actuarial assumptions and the funding methods, which are not uniform.

Business Week conducted a survey of 100 large corporations in 1981, and found they had pension assets of $134 billion to offset liabilities of $123 billion.

At BEA we do a survey of 40 major corporations that cover about one-fourth of the assets in the country, and one-sixth of the labor force of people covered by ERISA.

In that case, we found 40 major corporations have $74 billion in pension assets, covering $72 billion in vested benefits. In the aggregate then, we don't have a problem, but we do have a problem with some specific companies.

The PBGC has found that in terminations the unfunded guaranteed liabilities are roughly 85 to 90 percent of the unfunded vested liabilities. The "problem" companies are the ones where unfunded vested benefits exceed 30 percent of net worth.

How many companies are we talking about? Alicia Munnell, in the next presentation, will have more specific data, but most of our studies have shown on the computer screens of 1,000 or 2,000 largest corporations about 3 or 4 percent fall in this range of having unfunded vested benefits in excess of 30 percent net worth.

This was the problem we had at the PBGC advisory panel. How do we prevent the 96 percent of companies that are reasonably well funded from having an incentive to leave the system?

If we raise the premiums too high, the well-funded plans would have an incentive to withdraw from the system, and we would then lose the ability to tax them on the head tax. So we really have 3 or 4 percent of the companies being problem companies, likely to draw upon the PBGC.

How to identify the problem companies? Moody's, which is one of the bond rating agencies in New York, became concerned about this problem a few years ago and solicited information on the funding methods, the actuarial assumptions, the strength of the company's balance sheets and the very questions Professor Woodruff mentioned.

Some of this work has been done, but only on large corporations. Moody's found the bond ratings tended to reflect the underfunding problem. In other words, a company with pension liability problems, such as Braniff, has other problems as well, so you have well-funded companies and you have problem companies that have a multitude of problems, such that you are talking about whether you can salvage the company, let alone salvage the pension plan.

Mr. Regan. The problem companies tended to be mature cyclical industries, such as autos, steel, tire and rubber. It is not any secret that those companies do not have adequate assets to cover their pension liabilities. With every new labor contract that is negotiated, those pension liabilities tend to soar.

As is shown in figure 2 of the handout material, only 16 of the 40 companies in our survey had any unfunded vested liabilities, an in most cases the unfunded obligation was equal to less than 25 percent of the value of the value of the pension fund. The average fund grew by 25 percent in 1980. Thus the vast majority of companies are not the problem. It is very small portion.

What can we do? Alicia will talk about specifics on problem companies. Our suggestion to keep the strong companies in the system would be to retain the head tax but, at the same time, go to 100 percent of net worth to attach the assets and have the PBGC being able to reach the assets of those problem companies.

If worse came to worse, the Treasury could guarantee the liability since these payments are not due all at once, they are due in terms of cash flow. This would protect the 28 million people who are covered by the PBGC. Funds may not be needed, as was the case with the Chrysler Corp. They are guaranteed, but not have been touched.

The Chairman. Thank you very much, Mr. Regan.

Let me ask two general questions of you, and just give your names so the record will show who made the response.

First, give an idea about how important the private pension system is to the country. How many people would you say are covered by private pension plans in the country?

Mr. Regan. Twenty-eight million.

The Chairman. Twenty-eight million. How many companies have pension plans? You used a figure of 2,000?

Mr. Regan. No. I said that we have statistical data on 2,000 companies in computer data banks. Not all of those companies have pension plans. Some have profit sharing plans. Most have one or the other. You don't want to create an incentive to get away from pension plans toward profitsharing plans.

The CHAIRMAN. You say about 28 million people, employees who are covered by pension plans throughout the country. In how many of those plans does the employer put up all of the contribution and how many does the employee share in the contribution?

Mr. REGAN. The vast majority are noncontributory. The employer puts up the money. I can give you some exact statistics, but I don't have them with me.

The CHAIRMAN. That is where one of you raised the question about no legal obligation on the part of the employers, to continue to maintain a program only to match the employer. Is that correct?

Mr. GORDON. Mr. Chairman, yes, it is correct in two senses, but they are slightly different. Prior to ERISA employers were not required legally to be responsible for unfunded liabilities that were left around after a plan terminated, nor were they responsible prior to ERISA for funding the so-called prior cost or past service liability.

Now, after ERISA there is responsibility to fund, and there is responsibility up to 30 percent of net worth, in the case of single employer plans, to pick up unfunded liabilities after termination, but there is no legal responsibility to maintain a pension plan.

The CHAIRMAN. What about, Mr. Gordon, cases where there is an agreement, a labor management agreement with respect to the mechanism of pension plans? Would that be a contract enforceable by individual retirees?

Mr. GORDON. There are some courts which have certainly held that. There are some collective bargaining agreements which specifically give the labor organization the right to bargain about any type of plan termination and, in fact, there are some labor agreements that specifically require agreement between management and a union before the plan can be terminated.

By no means is this a uniform policy. Also you have a situation under which about approximately 50 percent—I could be corrected by my statistician friends, but I would guess about 50 percent—of single employer plans are not collectively bargained, or 50 percent of the members in single employer plans are not covered by collective bargaining agreements.

So, in those instances there is no protection whatsoever.

The CHAIRMAN. What is the right of the employer and the employee in respect to the ownership of the beneficial interest in that fund? Whatever fund they have been accumulating?

Mr. GORDON. Right now the law seems to be that the beneficial interest extends to the vested interest, the nonforfeitable interest of the employees in the fund.

To the extent that the employer has satisfied the vested interest in the fund, he is entitled under various theories, some of which might be tested quite soon, to recover supposedly what is left over as surplus that is not needed to satisfy——

The CHAIRMAN. We will come to that further. In general, if an employer terminated a pension funding program, what happens to those assets that have already been accumulated?

Mr. GORDON. Assuming we are talking about a defined benefit plan subject to the requirements of PBGC there is a complicated process in which the assets have to be measured and determined as to what is available to satisfy the unfunded vested liability and what isn't there has to be made up by PBGC.

That is a very oversimplified view of the way the process works. All of the assets in the plan have to be used to satisfy the vested liabilities that are owed——

The CHAIRMAN. Those who say the vesting period of 10 years' employment by an individual employee, suppose he has only been there 9 years and then if the employer terminates, that fellow doesn't get anything, does he?

Mr. GORDON. Not unless the plan specifically provides for it. He doesn't get anything the way ERISA is set up. There may be specific rights granted to him in addition to those rights granted by ERISA, but generally that is not the case.

The CHAIRMAN. One other question.

I believe you stated, Mr. Woodruff, that there have been 75,000 bankruptcies in the last year. In how many of those cases were there pension programs? How many of them were adequately funded?

Mr. WOODRUFF. Mr. Chairman, I said that if the current rate continued this year, this year we would see 75,000. Those were first quarter figures of this year.

The CHAIRMAN. I think I saw the figure in the paper the other day that the census depression or recession, whatever you call it, they have 141,000. Do you recall that figure? Does it seem like that?

Mr. WOODRUFF. No, Mr. Chairman, I don't. The rate of business failure is, at this current level, about 80 per 10,000 companies. At the height of the depression it was only at 100 per 10,000 companies. So, we are approaching depression levels in this country with business failures.

The CHAIRMAN. In how many of those instances, how many of those companies had pension programs and how many of them had their pensions adequately funded so that in spite of the bankruptcy of the company the employees receive their benefits according to the plan?

Mr. WOODRUFF. I don't know the figures for that quarter. The report that just came out was by Dun & Bradstreet. In the past the PBGC experience has been that most of the plans in terminating and business failures have been able to cover at least what are called the vested benefits under the plan.

This still means that in situations like you mentioned, where the individual has 8 or 9 years of service, they still may forfeit those benefits. So, the figures are somewhat misleading when they say that the funding was adequate.

It means the funding was adequate to pay the vested benefits but still there might be millions of dollars forfeited in accrued benefits that were not yet vested because of business failure.

The other point I was trying to make, Mr. Chairman, is that as the climate worsens in the economy, we are beginning to see whole industries coming into trouble. As we move from this sort of small, very periodic, almost predictable small business failure into medium- and large-size business failure, we are starting to see two things.

One is that companies with an older work force are beginning to fail now. In these older work force industries they funded their past service credits by amortizing the benefits over 30 years.

As we see this happening more and more, I think there are some real danger signals ahead for the premium levels that have to go up dramatically and then all of the equity questions that we mention in our testimony.

The CHAIRMAN. Two additional questions. One is, you all made recommendations which we appreciate. Have you had an opportunity to—I am not aware what the contribution to PBGC is. Do they get a certain amount from each pension program, like an insurance fund?

Mr. WOODRUFF. Currently there is a per capita premium, annual premium of $2.60 paid into two separate trust funds.

The CHAIRMAN. If it is an employer-funded program, the employer pays that?

Mr. WOODRUFF. If it is a defined benefit plan—the 28 million participants that was mentioned earlier is an estimate, it is 28 to 30 million people who are in what are called the defined benefit plans—those are the only plans insured by PGBC.

There are tens of millions of other employees in the defined contribution profit-sharing plans and the estimates are that a total of about 40 to 42 million people are in all plans altogether 28 to 30 million are in the PBGC.

In those plans, these plans' sponsors, the employer is responsible for paying a per capita, or the pension trust itself is responsible for paying a per capita tax, essentially, of $2.60 per head in the plan.

The indication is that the PBGC will be asking for that premium, the single employee——

The CHAIRMAN. It seems somewhat like the insurance fund of a savings and loan industry. If all of them went under, there wouldn't be nearly enough in the fund to pay the beneficiaries the amount they would be entitled to receive.

Now, let me ask each one of you this question. It is the last question.

Have you had an opportunity to examine our bill, H.R. 3396, which was introduced by members of our committee, the purpose of which was to have every employee covered by a pension program with Government encouragement and proper deductions?

The idea was we were trying to do two things: to start stronger and more effective and meaningful pension programs for the retiree, and also increase savings. We had savings benefits that we offered in that plan, to supplement the savings that a retiree would have so that the two pensions and savings would supplement the social security benefits that the individual is entitled to.

Have you any comment to make, Mr. Gordon, on the application of that principle of universal pension coverage for all of the employees?

Mr. GORDON. Mr. Chairman, I think it is an estimable goal. I think something like that, some form of integrated national retirement system which consists of both social security and private pension benefit plans is something that we have to head for in the future.

I think the problem now is the question of timing—to the extent that you have to put employer money into this type of operation—that is going to put even greater strains on existing defined benefit plans, as well as intensifying the problems that we all know about with regard to the financing of social security.

The CHAIRMAN. Thank you. I want to get a complete opinion.

Mr. Woodruff?

Mr. WOODRUFF. Yes, Mr. Chairman.

As you may know, I am a strong advocate of your legislation, particularly an advocate of the principle of a universal pension for everybody. I think one of the problems that you are going to hear stated over and over again today by other witnesses following us this morning and this afternoon is that we cannot raise the premium levels, we cannot improve the minimum funding standards, we cannot close the loopholes because if we do that, companies will start terminating their plans.

That is one of the dilemmas that we have with ERISA and any attempt to regulate a voluntary system. If you make the system work, people will stop funding them. They will terminate them. Then people will be left unprotected. So, we have to have a universal system.

The CHAIRMAN. Mr. Priest?

Mr. PRIEST. Yes, sir. I am unfamiliar with specifically H.R. 3396. However, I might add that the purpose of ERISA was to maintain the integrity of the private pension system and how best do you do that? That is going to be by making the individual who made the promise responsible for keeping them. To mandate an additional cost upon them I feel would be aggravating the situation we have today.

The CHAIRMAN. Mr. Regan?

Mr. REGAN. My only comment is that some of these problems can be resolved by resurrecting the concept of portability so that no matter where an individual works, whether it is at Braniff, Pan Am or any other airline or industry, he builds up credit for the time served there and it is portable, the pension goes with him.

The other aspect might be to have accelerated vesting. If a company wants to terminate, they have to vest everyone so you don't have people working 9 years getting left out of the pension because they didn't meet the time periods.

The CHAIRMAN. Mr. Daub?

Mr. DAUB. I have never had a chance to get so many experts in one place on the subject so close to the heart.

First I will say that we have to be very careful as we react to the current situation that we don't take away, as was just last said, the responsibility of the business itself, the managers of those funds. If we overprotect them they will say let's not worry how we invest and manage and do all of these things because ultimately the Government will take care of it if we go broke.

We have to be very careful that we don't try to say to managers and businesses, look, you don't have to worry about how you select your trustees or how you decide on what kind of annuities you use or investments you make because if you do have a problem, even if the actuaries are right, don't worry about it because the Government will bail you out. We have to be very careful not to head down that road.

Let's, for the audience's sake and for others who may hear, let's get a definition on the table of the defined contribution as distinguished from the defined benefit plan. Who wants to do that real quick?

Mr. WOODRUFF. Well, defined benefit plan is a plan where an ultimate benefit is stated in the plan. For instance, it may say a common salary related benefit plan would be say 1.5 percent times final 5 years of salary. A benefit is stated in the plan, and it comes under the guarantee provisions of the PBGC.

In a defined contribution plan, whether it is an employer only or jointly funded by employers and employees, the only obligation on the part of the employer is to put a certain amount of money each year in the plan.

There is no ultimate benefit stated that there may be a target using different assumptions and there therefore is no benefit guarantee provided by ERISA or any other Government regulation.

Mr. DAUB. So what is the trend now as you see it? Which way are we headed? Choosing to offer the defined contribution or choosing to offer the defined benefit?

Mr. WOODRUFF. I think there is a trend for both. I think that if you look at a number of plans, you see more defined contribution plans, though in the last couple of years we have seen a flurry of small defined benefit plans as well.

I think more and more employers are beginning to offer both, realizing that they serve maybe slightly different purposes.

Mr. DAUB. Is there any logic to pursuing why, since ERISA was adopted, Mr. Gordon, employers are just deciding to close them down?

Mr. GORDON. Well, it is obvious that after ERISA was enacted there was somewhat of a rush in the single employer field among smaller employers to try to shift from the defined benefit plans to defined contribution plans simply because it appeared to be less costly.

I think that particular trend sort of bottomed out a couple of years ago. There are other reasons as well. Some of the restrictions in terms of fiduciary principles on defined benefit pension plans are somewhat more burdensome, particularly in the conflict of interest area, than they are in defined contribution plans.

Whether they should be that way is another matter, but they are. However, obviously when you have an economy in trouble, the desire and incentive to limit cost burdens and other responsibilities comes to the forefront, and from that point of view one can understand why a number of employers will tend to regard a defined contribution rather than a defined benefit plan as a more prudent business decision for them to make.

I think what we face here in trying to erect a more effective funding-insurance structure is to make sure that in doing that we don't completely undermine the defined benefit plan system itself.

Mr. DAUB. The other problem I would worry about would be a comment, Mr. Priest, I think you made; that is, we want to assure there is no shift to the profit-sharing plan. Would you tell us why you say that?

Mr. PRIEST. Depending on the nature of one——

Mr. DAUB. What is wrong with a well-planned and funded profit-sharing plan as opposed to annuity?

Mr. PRIEST. The defined benefit is a somewhat hazy cost to the corporation, whereas in a defined contribution he is aware of when he makes it each year. It may be due to the nature of his business he would prefer a more variable cost structure and would do that for that reason.

On the other hand, I thought several years ago we would see much the opposite, simply because as long as the option exists, you then have a shared risk. If some day you may be in a position to exercise your option—particularly when section 4023 was around—but with a 30 percent rule it can still be there because you may have a corporation where in effect 30 percent of the market value of the company is less than what the claim is.

You start to create an incentive for people to terminate and indeed create a defined benefit system because at that point it is shared. The cost would be shared.

Mr. DAUB. But you didn't mean to say that you feared a company that was well managed, that wanted to offer a profit-sharing plan pure and simple, as opposed to the other kinds that may be optioned in their business?

Mr. PRIEST. Not at all.

Mr. DAUB. Now, let me ask you, I think as I read a lot of the things about you, that you have an idea that the Treasury could guarantee the PBGC with an emergency fund instead of boosting premiums to too high a level? Would such a scheme allow for a retrospective boost in the premium rather than a prospective one?

Mr. REGAN. That was something that I mentioned. It was something that was discussed on the PBGC CELI panel. We had to think this through as to what companies would have an incentive to dump obligations. We did not want to set a premium so high that we would have well-funded companies withdrawing.

American Telephone has 1 million employees. When you talk about an increase from $1 a head to $2.60 to $6, they are paying a large premium. They will never go bankrupt.

The guarantee idea came up about the time Chrysler was on the problem list—we had the Lockheed experience as well—something where you could guarantee liabilities but not step in and say I am going to make good the liability. It would be a temporary standby mechanism for the PBGC, just as you do on the FDIC.

Mr. DAUB. Was your study conclusive to the extent you felt it wouldn't have a factor of impact on the per capita head?

Mr. REGAN. The object was to hold that down.

Mr. DAUB. You didn't see a reaction to that later on down the road?

Mr. REGAN. The problem is that pension funds are invested primarily in stocks and bonds of other companies. As a consequence, when the economy turns down, the profits go down, stocks turn down, and these companies go bankrupt at a time when their pension funds are at a low point.

So, everything would happen at once. There would be a call on the PBGC. Rather than forcing PBGC to raise premiums at the worst possible time, it made sense to recommend the standby if only to instill confidence.

Mr. DAUB. I have just a couple more questions, very quickly.

Mr. Gordon, to you, some pension experts question the wisdom of subordinating claims of the PGBC to claims of all other creditors. Could you tell us the original rationale for that policy and do you believe there is any reason for change in the current provision of the law?

Mr. GORDON. Well, that was not the original provision in the law. The original provision of the law, PBGC had—and still does, as far as I know—under the single employer program a lien on an employer's assets second only to a tax lien. So, it took ahead of all other general creditors.

That has raised hackles in the business and financial community, but then along came the 1980 multiemployer amendments and they, along with several other revisions, to, I guess, make it more palatable, changed that so that now PBGC, as far as the multiemployer provisions are concerned, does have to scramble with the general creditors.

Now, whether that is a sound approach or not, I don't know. I would like to comment on your previous question to point out that what I understand—and it may be incorrect—is that one of the reasons that the Treasury Department decided to go along with the bailout provisions for Chrysler was because that was a relatively less expensive way to do it than to let Chrysler collapse and have to pay off all of these unfunded pension benefit liabilities through termination insurance and a potential Treasury guarantee.

Mr. DAUB. I wasn't here at that time, so I wouldn't have to take responsibility for those kinds of rumors.

Mr. GORDON. It is an interesting idea. It may be one of the ways to keep our economy afloat, to keep this uncertainty about the fate of pension insurance alive. The more ambiguous it is, the more a likelihood there may be that we will try to find some way to keep our companies going.

The CHAIRMAN. I just wanted to say that I was here and I voted for bailing out Chrysler, and I hope our decision to do that is being vindicated in the survival of Chrysler, with all that means to the economy. I have personally regretted that we still don't have a VSC like we had back in the New Deal days, which could have helped maybe a good many companies to survive with all of the attendant advantages that would have accrued from that.

Mr. GORDON. I agree with that Mr. Chairman. I think that might be a way to avoid a number of these very hard, if not insoluble, problems in the pension insurance field.

Mr. DAUB. Let me respond to that at another time and try to focus on a question. Can anyone tell me if—maybe we should properly direct this question to Mr. Jones, if it has the discretion not to cover a plan at the outset? In other words, you might qualify and you might send the check, the per capita tax, but the board says, "We don't want to cover you, we think you are too much of a risk."

Mr. GORDON. I don't believe that——

Mr. DAUB. I didn't mean to set off a bombshell, but I think you should think about that whole question.

Mr. GORDON. There was such a provision to deal with the problem of plans that terminated prior to the enactment of ERISA, the so-called retroactive terminations. PBGC was given discretionary authority to decide whether or not, based on certain criteria, they could go in and cover those terminations.

With respect to postenactment, terminations, I really don't think that they have that kind of discretion, although there is, I think, some play in terms of the fiduciary principles involved.

Mr. DAUB. I think, after the fact, they can start to look at the danger coming onstream and they can go in and tell them they will be forced to terminate.

But my thought was, what if the rule said simply that there had to be a study, actuarily, and you had to apply for admission to this little pool of insurance that is available out there, or are you just plain not going to take advantage of the 28 million other contributions being made to protect your mismanagement?

Mr. GORDON. Another way of doing that, Mr. Chairman, is to give PBGC the discretion to say you can't terminate a plan.

Mr. PRIEST. If I might add to that, in effect, for the PBGC not to be at risk, it must act before it has any of its equity at stake. That will be under the present law when the market value of companies three and a third times invested liability. If you make it 100 percent, you are dealing with these few specific instances that can be handled as a special issue entirely.

Mr. DAUB. I appreciate all of your answers, and we thank you very much.

The CHAIRMAN. We thank you very much for the valuable contribution you made today.

We have now panel number two, and we planned it in our hearings that we generally put a little too much time with the first panel, and sometimes we don't have time for all of the other panels. We have four extra panels here today, and I hope we can adequately hear each one of them because they have something very valuable to contribute.

Panel number two is Mrs. Alicia Munnell, economist, vice president, Federal Reserve Bank, Boston; Mr. William Scheri, airline coordinator, International Association of Machinists & Aerospace Workers; and Mr. Edwin Jones, executive director, Pension Benefit Guaranty Corp. of Washington.

Ms. Munnell, we will have you first. I will say to each one of you, if you have a written statement, we will be glad to put your statement in full in the record and let you summarize it, and that way we will save a little time. But I want you to do whatever you think you would rather do. First will be Ms. Munnell.

PANEL TWO, CONSISTING OF ALICIA MUNNELL, ECONOMIST, VICE PRESIDENT, FEDERAL RESERVE BANK, BOSTON, MASS.; WILLIAM SCHERI, AIRLINE COORDINATOR, INTERNATIONAL ASSOCIATION OF MACHINISTS AND AEROSPACE WORKERS, ACCOMPANIED BY LANNY ROGERS, PRESIDENT AND DIRECTING GENERAL CHAIRMAN, IAM DISTRICT NO. 146, DOUGLAS KUHNS, ASSISTANT DIRECTOR OF RESEARCH, IAM, WILLIAM G. MAHONEY, COUNSEL, AND CLINT MILLER, COUNSEL; AND EDWIN JONES, EXECUTIVE DIRECTOR, PENSION BENEFIT GUARANTY CORPORATION, WASHINGTON, D.C., ACCOMPANIED BY LAWRENCE MASLAN, DIRECTOR, OFFICE OF FINANCIAL OPERATIONS, HENRY ROSE, GENERAL COUNSEL, GERALD E. COLE, JR., ASSISTANT EXECUTIVE DIRECTOR, OFFICE OF POLICY AND PLANNING, AND JOHN HIRSCHMANN, CHIEF, DIVISION OF FINANCIAL AND ACTUARIAL PROGRAM DEVELOPMENT

STATEMENT OF ALICIA MUNNELL

Ms. MUNNELL. Thank you, Mr. Chairman. I am sorry for the delay.

My name is Alicia Munnell, vice president economist from the Federal Reserve Bank of Boston. I have written extensively on public pensions, private pensions, and the social security system. I have a prepared statement for the record, and I will try to summarize my main points.

I would like to talk about three aspects of the financial future of the PBGC. First, the incentive for financially viable businesses to terminate their plans; second, the incentive for large companies to spin off faltering subsidiaries with large unfunded liabilities; and third, the likelihood of termination among financially troubled companies and the potential impact of termination of large plans on the finances of the PBGC. My conclusion is the PBGC is in an extremely vulnerable financial position, but there are several alternatives available.

First, termination of viable companies. Prior to ERISA, if a firm terminated its plan, employees were guaranteed benefits only insofar as the assets in the pension fund were adequate. Now the PBGC guarantees the payment of vested benefits even if the plan terminates with insufficient assets. Moreover, the agency can hold the employer liable for unfunded benefits up to an amount equal to 30 percent of the net worth.

Limiting the company's liability, however, to a fraction of net worth makes it advantageous for companies with large unfunded liabilities to terminate their plans. Theoretically, for any company with unfunded liabilities in excess of 30 percent of net worth, the company could borrow the amount equal to 30 percent of net worth, terminate its plan, pay off its liabilities to the PBGC, and the PBGC would alleviate it of all of its unfunded burden in excess of that amount. The firm could then repay the loan with the money that otherwise would have gone toward pension payments.

In 1980, 86 of the 6,000 publicly traded companies for which records are kept by the Standard & Poor's Compustat Services had unfunded liabilities in excess of 30 percent net worth. If all of these firms terminated their plans, the PBGC would have faced a liability of about $4 billion in 1980.

Of course, practical considerations prevent most companies from arbitrarily terminating their plans. Most companies do not have sufficient retained earnings to pay off the PBGC liability. It is difficult to borrow money for that reason. Also, firms like to maintain a reasonable collective bargaining atmosphere, and they want to avoid litigation that is usually associated with termination of the plans.

However, while most firms do not arbitrarily terminate their plans, companies are aware of the important role that PBGC can play, and some companies have taken advantage of the PBGC provisions.

A recent case involved AlloyTek—the largest employer in Grand Rapids, Mich. The company, financially pressed as a result of the purchase of a new plant, announced that it was going to terminate the plan supporting 400 retirees and 380 active workers. While the PBGC agreed initially to absorb the $5 million unfunded pension liabilities, the agency balked when it realized the company was going to establish a new plan. AlloyTek sued the PBGC, but the two parties settled out of court in September 1981. The PBGC agreed to assume the bankrupt plan if the company dismantled the newly established plan. However, the agency did allow the company to raise all wages and salaries by 7 percent and let the firm establish IRA's for its employees.

This is a very important case since it demonstrates that companies can abandon old pension plans, transfer the burden of unfunded benefits to the PBGC, avoid employer liability because of temporarily low new worth, and then establish IRA's for their employees.

In order to discourage this type of occurrence, that is, to prevent ongoing firms from terminating their pensions, and transferring the burden to the PBGC, the single employer insurance program should be amended so that the insurable event is changed from voluntary plan termination to the bankruptcy of the employer.

Turning now to the second problem associated with large companies spinning off weak subsidiaries with substantial unfunded liability. The PBGC is currently suing International Harvester in connection with its sale of Wisconsin Steel in 1977. The suit charges that Harvester sold the company just to minimize the cost of unfunded pension benefits and Harvester knew the steel company was not a viable entity on its own.

In order to avoid the problem that arises when a strong company sells or spins off a faltering subsidiary with large unfunded liabilities, the parent company should have a contingent liability for some period of time, should the separated company terminate its plan and make a claim on the PBGC. It is not clear to me whether that period of time should be 5, 10, or 15 years, but some sort of contingent liability should be established.

Finally, I would like to turn to PBGC's exposure from financially troubled companies. Most terminations have not resulted from spinoffs or the simultaneous establishments of new plants, but rather have been associated with serious financial problems or bankruptcy on the part of the plan sponsor. In order to isolate those of the 86 firms that I mentioned earlier with the particularly likelihood of termination, we applied a profitability and pension burden screen to those firms and came up with a list of 22 firms with unfunded liability in excess of 30 percent of net worth and with a higher than average likelihood of termination.

The unfunded liability in 1980 for these firms represented about $3 billion. While no one would suggest all of these firms will terminate their plans, the data do indicate that the PBGC is in a financially vulnerable position. Recent experience of some of the 22 firms on the list tends to support this assessment. Rath Packing has deferred funding payments, Penn-Dixie has liquidated the plan of a subsidiary, Braniff has declared bankruptcy, and the financial future of International Harvester is touch and go.

There are serious implications to increased terminations. The PBGC is already requesting a premium increase from $2.60 per participant to $6 per participant. By necessity, this requested rate increase is based on an extension of historical experience. There is no provision for terminations of plans with unfunded liabilities in excess of $60 million. Should some large companies terminate, $6 will be grossly inadequate. For instance, if International Harvester terminated its plan, an additional premium would be required of between $4 to $7 per participant for that one company alone.

High premiums would create havoc with the program. Increased burden might cause other pension plans to terminate and, as mentioned earlier this morning, the simple per participant rate structure no longer will be acceptable. You already hear rumblings that well-funded firms will resist even the $6 premium rate.

One way to limit future PBGC claims arising from the legitimate termination of inadequately funded plans would be to change the basis for calculating employer liability. The PBGC is currently subordinated to all other corporate creditors. It can appropriate only 30 percent of those assets in excess of all other corporate liabilities. It comes last.

It is unclear to me why, if pensions are supposed to be serious commitments, that the claims of employees to what are certainly deferred wages should be subordinated to all other corporate obligations. In order to establish equitable treatment for workers and to reduce potential claims on the PBGC, it may be useful to consider calculating employer liability on the basis of firm assets rather than just the excess of assets over liabilities as we do now. It may be very controversial, but the current system is very difficult to rationalize.

In conclusion, the PBGC faces financial pressures on two fronts. One problem arises from what must be described as abuses of the original intention of the Pension Benefit Guaranty Corporation. Ongoing firms that terminate substantially underfunded plans and simultaneously establish new retirement provisions, and companies that spin off weak subsidiaries with large unfunded pension liability put unnecessary strain on the PBGC.

These abuses can be prevented if, one, the insurable event is changed from termination to insolvency; and two, a contingent liability is established for parent companies that transfer subsidiaries with unfunded pension liabilities.

The second source of financial uncertainty arises from the intended function of the PBGC. Many large companies, weakened by prolonged periods of high interest rates, rising costs, and a depressed economy may be forced into bankruptcy. One way for the

PBGC to avoid the financial burden would be to raise the priority of the agency's claim so that it has access to corporate assets rather than new worth. That may be a very unpopular idea among plan sponsors, but the financial vulnerability of the single employer insurance scheme might force Congress to choose among three unpalatable options: One, reducing benefit guarantees; two, subsidizing the PBGC from general revenues; or three, elevating employee claims to the priority of other corporate creditors.

Thank you, Mr. Chairman.

The **Chairman**. Thank you, Ms. Munnell, for an excellent statement.

[The prepared statement of Ms. Munnell follows:]

Prepared Statement of Alicia H. Munnell*

My comments this morning will address three developments that will affect the financial future of the PBGC. First, I would like to discuss the incentive for financially viable businesses to terminate their pension plan in view of the 30 percent of net worth limit on employer liability. A worrisome precedent has already been established by one ongoing company with very low net worth that has terminated its plan, transferred its liability to the PBGC, raised all wages by 7 percent and established IRAs for its employees. Second, I would like to highlight the evolving problem associated with large companies spinning-off faltering subsidiaries with substantial unfunded liabilities. Finally, I would like to speculate about the likelihood of termination among financially troubled companies and the potential impact on the PBGC of a number of terminations by large employers. My conclusion is that the PBGC is in an extremely vulnerable financial position, but that some options are available.

I. Terminations by Viable Companies

From the perspective of corporate financial managers, the establishment of the PBGC may be the most important part of the ERISA legislation. Before 1974 firms were not legally liable for the payment of unfunded vested pension

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*Vice President and Economist, Federal Reserve Bank of Boston. The views presented are those of the author, and do not necessarily reflect official positions of the Federal Reserve Bank of Boston or the Federal Reserve System. These comments are based on the results of the author's study, "Guaranteeing Private Pension Benefits: A Potentially Expensive Business," New England Economic Review (March/April 1982).

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nefits. If a firm terminated its pension plan, employees with veste pension claims would receive benefits only insofar as the pension fund w adequate. Now the PBGC guarantees the payment of vested pension benefits ev if the plan terminates with insufficient funds. Moreover, the agency can hol the sponsoring company liable for the underfunding up to an amount equal to 30 percent of the company's net worth. This contingent liability provision wa designed to foster a sense of prudence on the part of the employer in both setting benefit levels and funding the accruing costs of benefits, t discourage unnecessary terminations, and to provide another source financial support for the PBGC.

Limiting the company's liability to a fraction of net worth, however, makes it advantageous for companies with large unfunded liabilities to terminate their plans. Theoretically, any firm with unfunded benefit commitments in excess of 30 percent of net worth could simply borrow an amount equal to 30 percent of its net worth, terminate its plan, and pay off its contingent liability to the PBGC with the proceeds of the loan. The PBGC would then relieve the firm of all unfunded liability in excess of 30 percen of its net worth. The loan itself could then be repaid with the money that would otherwise have gone toward annual pension payments. As shown in Table 1, 86 firms had unfunded liabilities in excess of 30 percent of net worth in 1980; if all these firms terminated their pension plans the PBGC would face a potential claim totaling $4.3 billion after deduction of employer net worth.

Of course, several practical considerations prevent companies fro arbitrarily terminating their plans. Most firms do not have sufficie

Table 1. PBGC Exposure from Firms With Underfunded Pension Plans, 1980

Firm	PBGC Exposure: Unfunded Liability	PBGC Exposure: 30 Percent of Market Net Worth[a]	PBGC Exposure: Potential PBGC Liability	Incentive to Terminate: Profitability[b]	Incentive to Terminate: Pension Burden[c]	Incentive to Terminate: Benefit per dollar of cost[d]
	($ millions)					
1. Chrysler	$1,275.3	$286.0	$989.3	-15.1%	2.4%	$4.46
. International Harvester	1,079.0	214.6	864.4	-2.1	2.9	5.03
3. Uniroyal	509.0	81.6	427.4	3.3	3.6	6.24
. Health-Chem Corp.	433.1	34.2	399.0	9.9	0.3	12.67
. American Motors	226.0	62.0	164.0	-2.5	2.1	3.65
. Trans World Corp.	312.0	175.7	136.3	2.0[e]	2.4	1.77
. Pan American	221.9	89.4	132.5	3.9	2.7	2.48
. Allis Chalmers Corp.	232.1	106.2	125.9	7.6	2.2	2.19
. Wheeling-Pittsburg Steel	174.9	53.8	121.1	3.4	6.4	3.25
1 . Braniff International	138.9	23.3	115.6	-5.2	2.1	5.97
1 . Republic Steel Corp.	223.0	132.3	90.7	2.7	4.1	1.69
1 . Bethlehem Steel Corp.	420.2	339.0	81.2	5.2	4.3	1.24
1 . Rath Packing	71.0	3.8	67.2	-2.4	2.1	18.68
1 . Goodrich (B.F.)	184.5	126.7	57.8	5.5	1.7	1.46
1 . Cyclops Corp.	80.1	34.3	45.8	6.3	2.6	2.34
1 . Anchor Hocking Corp.	92.3	54.2	38.1	10.5	2.8	1.70
1 . CF&I Steel Corp.	79.0	43.4	35.6	4.7	4.7	1.82
1 . Laclede Steel Corp.	39.3	9.2	30.2	2.4	4.3	4.27
1 . Penn-Dixie Industries	32.7	4.6	28.1	-5.1	3.2	7.11
2 . Smith (A.O.) Corp.	46.0	21.9	24.1	5.4	2.1	2.10
. Facet Enterprises	28.1	4.5	23.6	1.9	3.8	6.25
2 . Wean United, Inc.	31.5	8.7	22.8	3.5	4.2	3.62
2 . Pheonix Steel Corp.	31.0	12.6	18.4	0.3	3.2	2.46
2 . GF Business Equipment	22.8	4.4	18.4	1.8	2.4	5.19
2 . Trico Products Corp.	32.4	15.1	17.3	4.1	2.9	2.14
2 . Lamson & Sessions Co.	26.6	9.8	16.8	5.1	2.5	2.71
2 . Keystone Cons. Industries	25.0	8.3	16.7	-1.3	3.8	3.01
2 NVF Corp.	103.7	88.3	15.4	3.8	2.5	1.17
2 Brockway Glass Co.	47.1	34.3	12.8	7.8	2.2	1.37
3 American Seating	15.6	3.8	11.8	-0.2	2.5	4.10

31. Hawaiian Airlines	14.1	3.6	10.5	1.0	5.5	3.91
32. Driver Harris Co.	11.2	1.8	9.4	1.0	2.7	6.22
33. McLouth Steel	19.7	11.6	8.1	-2.5	1.3	1.70
34. American Biltrite	14.9	7.7	7.2	0.4	1.2	1.93
35. AFG Industries, Inc.	21.0	14.1	6.9	4.2	1.9	1.49
36. Monolith Portland Cement	6.9	0.5	6.4	13.1	3.6	13.80
37. GRM Industries	4.9	0.7	4.2	9.4	1.9	7.00
38. Kerr Glass Mfg.	30.6	26.4	4.2	6.4	1.3	1.16
39. Baltimore & Ohio Railroad	22.2	18.0	4.2	3.3	0.8	1.23
40. Athlone Industries	24.7	20.6	4.1	11.5	1.6	1.20
41. Tobin Packing	5.0	1.0	4.0	-10.8	0.4	5.00
42. Mesta Machine	6.6	3.2	3.4	-8.2	5.8	2.06
43. United Merchants & Mfgrs.	12.5	9.7	2.8	0.9	0.7	1.28
44. GIT Industries, Inc.	3.7	1.0	2.7	5.6	1.7	3.70
45. Fort Worth & Denver RR	2.6	0.0	2.6	14.9	0.5	--
46. Ferry Cap & Set Screw Co.	2.5	0.5	2.0	6.0	3.3	5.00
47. Port Huron Paper Co.	4.0	2.0	2.0	3.5	0.7	2.00
48. Corduroy Rubber Co.	3.4	1.4	2.0	16.4	2.1	2.43
49. Crowley Milner & Co.	3.7	1.7	2.0	8.3	0.8	2.18
50. Whitehall Cement	5.0	3.2	1.8	4.3	3.2	1.56
51. Roblin Industries	5.7	4.1	1.6	-1.7	0.9	1.39
52. Plymouth Rubber Co.	4.2	2.7	1.5	0.4	1.2	1.56
53. Hastings Mfg. Co.	4.2	2.8	1.4	11.1	2.6	1.50
54. Dayton Malleable, Inc.	10.3	8.9	1.4	-0.5	3.7	1.16
55. Giant Portland Masonry Cem.	4.3	3.0	1.3	1.4	2.3	1.43
56. Sorg Paper Co.	4.9	3.7	1.2	8.2	0.8	1.32
57. General Refractories Co.	10.0	8.9	1.1	1.3	1.6	1.12
58.-86. Others[f]	33.7	26.1	7.6	N.A.	N.A.	1.29
Total	$6,530.6	$2,274.9	$4,255.7	N.A.	N.A.	$2.87

Source: Standard and Poor's Compustat Services, Inc.

[a] Market net worth is defined as the number of common shares outstanding for the latest updated year multiplied by the average of the high and low prices for the calendar year 1981 then plus the liquidating value of any preferred stock

[b] Profitability is defined as the firm's average pretax income over the period 1978-80 divided by the firm's average total assets over the same period.

[c] Pension burden is defined as the average pension and retirement expense incurred by a firm over the period 1978-80 divided by the firm's average sales over the same period.

[d] Benefit per dollar of cost is defined as unfunded vested liabilities divided by 30 percent of net worth.

[e] Trans World Corporation's profit of $20.5 million was totally attributable to a $47.2 million extraordinary item, without which earnings would have been negative.

[f] For the 29 firms included in this total, their unfunded liabilities exceeded 30 percent of their net worth by less than $1 million.

retained earnings to cover their liability and most lending institutions would be reluctant to provide loans for the purpose of plan termination. More importantly, perhaps, companies desire to maintain a reasonable climate for labor negotiations and are anxious to avoid the extensive litigation that plan termination can entail.

While most firms do not generally terminate their underfunded pension plans, companies are aware of the important role the PBGC can play and some have not hesitated to take full advantage of the pension guarantee. A recent case involved AlloyTek, the largest employer and taxpayer in Grand Rapids, Michigan. The company, financially pressed as a result of the purchase of a new plant, announced that it planned to terminate its pension plan which supported 400 retirees and covered 380 employees. While the PBGC may have agreed initially to underwrite AlloyTek's $5 million pension obligation, the agency balked when the company instituted a new pension plan for the 380 persons still employed by the firm. The agency argued that taking over AlloyTek's bankrupt pension fund while allowing the firm to begin a new pension plan would set a bad precedent encouraging other large companies to do the same.

As the two sides prepared for trial, the PBGC and AlloyTek reached an out-of-court settlement in the fall of 1981. The PBGC agreed to assume the bankrupt plan if AlloyTek dismantled its newly established pension plan. However, the PBGC did agree to allow AlloyTek to raise wages by 7 percent to cover the costs of buying Individual Retirement Accounts for its employees. At this time, AlloyTek's employer liability assessment remains an unresolved element in the case. However, since the firm maintained that net worth was

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negative in October 1979 when the old pension plan was abandoned, the PBCC assessment may not be significant.

The AlloyTek case is important since it demonstrates that companies can abandon old pension plans, transfer the burden of unfunded benefits to the PBGC, avoid assessment of employer liability because of low or negative net worth at the time of termination, and then establish IRAs for their workers. Since there are numerous firms for whom this is an attractive option, the AlloyTek situation establishes a worrisome, practical if not legal, precedent.

A primary motivation for the PBGC settling out of court in the AlloyTek case was to avoid establishing a legal precedent. Nevertheless, a similar case is currently in litigation in Oklahoma. Facet Enterprises, Inc. is suing the PBGC to force the agency to recognize the termination of the company's hourly pension plan in November 1980. The company's funding problems are a result of a series of events beginning several years ago when the Federal Trade Commission ordered Bendix Corporation to divest itself of some operations. Facet was formed initially as a wholly-owned Bendix subsidiary composed of various Bendix operations and then spun off as an independent, publicly-owned corporation in 1976. Among other things, Facet contends that the FTC in its spin-off action ignored the large unfunded obligations of Bendix pension plans.

Regardless of the origins of the unfunded liabilities, the PBGC has refused to implement the termination of the plan because it believes that Facet intends to establish a new retirement program for the workers. Indeed, as one of three options presented to the PBGC, Facet proposed the introduction of the Facet Enterprises, Inc. Hourly Employees Target Benefit Plan which

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would provide benefits similar to those provided under the hourly plan.

The PBGC's reluctance to absorb $24 million of unfunded pension liabilities were Facet to establish new retirement arrangements that provide essentially the same benefits is understandable. Nevertheless, if the court rules that the agency must meet those obligations, then any company whose unfunded liabilities exceed 30 percent of net worth could force the PBGC to absorb a major portion of the costs of its ongoing retirement program. In order to discourage ongoing companies from terminating their plans and transferring the burden to the PBGC, the single employer insurance program should be amended to change the insurable event from voluntary termination of the plan to liquidation of the plan sponsor.

II. Spinning-off Weak Subsidiaries

The Facet case also illustrates another developing problem for PBGC that pertains to strong companies spining off weak subsidiaries with substantial unfunded pension liabilities. For instance, the PBGC is currently suing International Harvester in connection with its sale of its Wisconsin steel company in 1977. The steel company has been in bankruptcy proceedings since March 1980 and the PBGC has been left with substantial unfunded pension liabilities. The suit maintains that Harvester helped support the steel company's pension plan after divestiture and therefore Harvester owes the PBGC $45 million just as if it had terminated the plan itself. The suit charges that Harvester sold the steel company simply to minimize the cost of vested pension rights earned by Wisconsin Steel employees while Harvester owned the operations. The suit alleges that Harvester knew the purchaser would not be able to operate the Wisconsin steel division as a profitable business. The

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outcome of this suit could determine whether firms can spin off faltering divisions in order to avoid the employer contingent liability payment to the PBGC.

The International Harvester and the Facet cases reveal that businesses are quite sophisticated about the PBGC provisions and that certain firms will always be testing the limits in terms of trying to shift their unfunded pension burden to the PBGC. In order to avoid the problem that arises when a strong company sells or spins off a faltering subsidiary with large unfunded liabilities, the parent company should have a contingent liability for up to 15 years in the event the transferred company terminates its plan and makes a claim against the PBGC.

II. PBGC Exposure from Financially Troubled Companies

Most terminations of plans with insufficient assets, however, have not resulted from spin-offs or the simultaneous establishment of new plans, but rather have been associated with serious financial difficulties or bankruptcy of the plan sponsor. In an attempt to isolate firms with a higher likelihood of termination, we identified those companies in Table 1 with low profits and significant pension costs. This was accomplished by applying a screen based on the profitability and pension burden criteria used in earlier PBGC studies. These financially burdened firms are shown in Table 2 and are ranked in terms of their financial incentive to terminate as measured by the ratio of unfunded liability to 30 percent of the company's net worth. For instance, if Rath Packing were to terminate its pension plan, the company could relieve itself of $71.0 million of unfunded pension liabilities, at the cost of transferring 30 percent of its market net worth or, in this case, $3.8 million, to the PBGC. Hence, the firm gains $71.0 million and forfeits $3.8

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Table 2. PBGC Exposure from Financially Burdened Firms,[a] 1980

Firm	PBGC Exposure: Unfunded Liability	PBGC Exposure: 30 Percent of Market Net Worth[b]	PBGC Exposure: Potential PBGC Liability	Incentive to Terminate: Profitability[c]	Incentive to Terminate: Pension Burden[d]	Incentive to Terminate: Benefit per dollar of cost[e]
	($ millions)					
1. Rath Packing	$71.0	$3.8	$67.2	-2.4%	2.1%	$1[illegible].68
2. Penn-Dixie Industries	32.7	4.6	28.1	-5.1	3.2	7.11
3. Facet Enterprises	28.1	4.5	23.6	1.9	3.8	6.25
4. Uniroyal	509.0	81.6	427.4	3.3	3.6	6.24
5. Driver Harris Co.	11.2	1.8	9.4	1.0	2.7	6.22
6. Braniff International	138.9	23.3	115.6	-5.2	2.[illegible]	5.97
7. International Harvester	1,079.0	214.6	864.4	-2.1	2.9	5.03
8. GF Business Equipment	22.8	4.4	18.4	1.8	2.4	5.19
9. Chrysler	1,275.3	286.0	989.3	-15.1	2.4	4.46
10. Laclede Steel Corp.	39.3	9.2	30.2	2.4	4.3	4.27
11. American Seating	15.6	3.8	11.8	-0.2	2.5	4.10
12. Hawaiian Airlines	14.1	3.6	10.5	1.0	5.5	3.91
13. American Motors	226.0	62.0	164.0	-2.5	2.1	3.65
14. Wheeling-Pittsburg Steel	174.9	53.8	121.1	3.4	6.4	3.25
15. Keystone Cons. Industries	25.0	8.3	16.7	-1.3	3.8	3.01
16. Pan American	221.9	89.4	132.5	3.9	2.7	2.48
17. Phoenix Steel Corp.	31.0	12.6	18.4	0.3	3.2	2.46
18. Mesta Machine	6.6	3.2	3.4	-8.2	5.8	2.06
19. Trans World Corp.	312.0	175.7	136.3	2.0	2.4	1.77
20. Giant Portland Masonry Cem.	4.3	3.0	1.3	1.4	2.3	1.43
21. NVF Corp.	103.7	88.3	15.4	3.8	2.5	1.17
22. Dayton Malleable, Inc.	10.3	8.9	1.4	-0.5	3.7	1.16
Total	$4,352.7	$1,146.4	$3,102.4	N.A.	N.A.	$3.80

Source: Standard & Poor's Compustat Service, Inc.

[a] To identify financially burdened firms, a double screen was used to isolate those firms whose ratio of pretax profits to total assets was less than .04 and whose ratio of pension expense to sales was greater than .02 over the period 1978-80.

[b] Market net worth is defined as the number of common shares outstanding for the latest updated year multiplied by the average of the high and low prices for the calendar year 1981 plus the liquidating value of any preferred stocks.

[c] Profitability is defined as the firm's average pretax income over the period 1978-80 divided by the firm's average total assets over the same period.

[d] Pension burden is defined as the average pension and retirement expense incurred by a firm over the period 1978-80 divided by the firm's average sales over the same period.

[e] Benefit per dollar of cost is defined as unfunded vested liabilities divided by 30 percent of net worth.

million for a benefit per dollar of cost of $18.68.

While no one would suggest that all these financially troubled firms will terminate their pension plans, the data do indicate that the PBGC is in a potentially vulnerable position. The recent experience of the firms listed in Table 2 tends to support this assessment. Rath Packing has deferred funding payments, Penn-Dixie has liquidated and terminated the plan of a cement subsidiary, Facet has terminated its plan and, as noted above, has sued the PBGC for support, Braniff Airlines has declared bankruptcy, and the financial future of International Harvester is touch and go.

The PBGC has already requested a premium increase from $2.60 to $6.00 on the basis of the projected deficiency in assets which is expected to increase from $189 million in 1981 to $448 million in 1986. These projections, by necessity, are based on the PBGC experience to date and therefore do not call for claims in excess of $60 million. Should some of the large companies listed in Table 2 terminate their plans, the $6 premium will be grossly inadequate. For instance, should a couple of large companies, such as Chrysler or International Harvester, either by choice or bankruptcy terminate their pension plans, the additional premium required would be about $17 per participant if the liability were amortized over 5 years and about $10 more per participant if amortized over 10 years.

High premiums would create havoc with the program. The increased burden might force other weak pension plans to terminate thereby putting additional pressure on the PBGC. Moreover, with a higher premium, the simple per participant rate structure would no longer be acceptable. The sponsors of well funded pensions may be willing to subsidize the insurance of seriously underfunded plans when the premium is trivial, but at levels that approach 2 percent of total pension costs there would be pressure to construct a risk related rate structure. Such a structure would increase the burden on precisely those firms least capable of withstanding higher pension costs.

One way to limit the future claims on the PBGC arising from the legitimate termination of inadequately funded plans would be to change the basis for calculating employer liability. The PBGC's ability to impose a tax lien in order to recover the employer's liability payment greatly exaggerates the favorable treatment accorded the agency's claims. In reality, the PBGC can be considered subordinate to other corporate creditors, since it can appropriate 30 percent of only those assets in excess of corporate liabilities to defray the cost of unfunded pension benefits. If the bankruptcy does not involve corporate reorganization, the excess of assets over liabilities is zero and the PBGC's claim is worthless.

It is unclear why, if pension promises are supposed to be serious commitments, the claims of employees to deferred wages should be subordinate to the claims of all other corporate creditors. The IRS, bondholders and other creditors look to corporate assets not to net worth to recoup their loans. In order to establish equal treatment for workers and to reduce the potential claims on the PBGC, it may be useful to consider calculating employer liability on the basis of the firm's assets rather than net worth. Clearly such a proposal would be very controversial and its adoption would involve a major change in the single employer insurance program, but the current subordinated status of workers' claims to pension benefits is difficult to rationalize and costly to the PBGC.

III. Conclusion

In summary, the PBGC faces financial pressure on two fronts. One problem arises from what must be described as abuses of the original intention of the single employer insurance program. Ongoing firms that terminate substantially underfunded plans while simultaneously establishing new retirement provisions and companies that spin off weak subsidiaries with large unfunded pension liabilities put unnecessary financial pressure on a vulnerable agency. Both these abuses can be prevented, however, if the insurance provisions are revised to 1) change the insurable event from termination to insolvency and 2) establish a contingent liability on the parent company for up to 15 years should a transferred company terminate its plan and file a claim with the PBGC.

The second source of financial uncertainty arises as a result of the intended function of the PBGC. Many large companies, weakened by prolonged periods of high interest rates, rising costs, and a depressed economy, may be forced into bankruptcy. One way for the PBGC to avoid the financial burden of substantial unfunded liabilities would be to raise the priority of the agency's claim so that it has access to corporate assets rather than simply to the excess of assets over all other liabilities. Such a change would place the employer's claim to deferred wages on a par with the claims of other corporate creditors and would significantly increase PBGC revenues from employer liability contributions. Even though such a proposal would be very unpopular among sponsors of private plans, the financial vulnerability of the single employer insurance scheme may force Congress to choose among three unpalatable options -- reducing benefit guarantees, subsidizing the PBGC from general revenues, or elevating employee's claims to the priority of other corporate creditors.

The CHAIRMAN. Mr. Scheri.

STATEMENT OF WILLIAM SCHERI

Mr. SCHERI. Thank you.

My name is William Scheri, airline coordinator for the International Association of Machinists & Aerospace Workers, and testify today as a designee of International President William W. Winpisinger. I am accompanied by Mr. Lanny Rogers, president and directing general chairman of IAM District No. 146, which includes the representation of employees of Braniff International Airlines within its jurisdiction; Mr. Douglas Kuhns, assistant director of research, IAM; and Mr. William G. Mahoney and Clint Miller, counsel to the IAM.

I will try to limit my comments to the time prescribed.

The IAM is a multi-industrial labor union which represents employees under about 6,000 collective-bargaining contracts in 350 industries, including those in aerospace, transportation, manufacturing, and construction.

Because of its immediacy and very large number of employees involved, I would like to focus my testimony on the IAM's particular concern for the pensions of the employees of Braniff International which just recently filed for protection from the creditors under chapter 11 of the Bankruptcy Code.

The impact of Braniff's bankruptcy on Braniff employees, passengers, and shippers has been immediate and severe. The ripple effects of Braniff's bankruptcy on the financial stability of aircraft manufacturers, parts suppliers, food service companies and other suppliers of essential goods and services, while not immediately discernible, cannot be discounted. Of particular concern to this committee, and the subject of my testimony today, is the impact of this bankruptcy on the pension plans covering various classes or crafts of Braniff employees.

Braniff currently contributes to four separate pension plans which, as of the year ending December 31, 1980, the last year for which complete information is currently available, included 9,536 active participants. These plans include, in addition to the plan covering 1,843 active participants represented by the IAM, the pilots' A plan with 2,099 active participants; the Braniff management plan with 1,144 active participants; and the plan covering the employees represented by the International Brotherhood of Teamsters with 4,450 active participants. Of the 1,843 active participants in the IAM pension plan, 1,321 employees were fully vested as of 1980. In addition to the active participants in the IAM plan, there were 189 employees receiving benefits as of December 31, 1980, and 93 deceased, retired or separated employees or beneficiaries who were entitled to receive benefits at some future date.

As a result of the severe economic problems experienced by Braniff discussed above, the viability of the various Braniff pension plans has steadily deteriorated since 1980. As reported in the March 1, 1982, edition of "Aviation Week and Space Technology," the assets of the various Braniff pension plans constituted only 43.1 percent of the total vested liability of these plans. On January 1, 1980, the total vested liability of the IAM plan amounted to

$34,075,000, with the value of the assets of the plan amounting to only $13,595,492, as of that date.

This funding deficit has steadily increased in the years since 1980 due to the waiver by the Internal Revenue Service of Braniff's minimum contributions for the year ending December 31, 1980, of $2,991,135, and Braniff's failure to make similar contributions to the IAM plan for the year ending December 31, 1981, and the anticipated failure of Braniff to make any contributions for the current year. Braniff has also failed to make contributions in this period to the three other pension plans described above in the total amount of $25,407,845 annually.

While the administrators of the various Braniff pension plans have not, as of this date, notified the Pension Benefit Guaranty Corporation of their intent to terminate these pension plans, such a voluntary termination by the plan administrators or an involuntary termination by the PBGC, as a result of Braniff's continuing inability to make the statutorily required minimum contributions, seems likely. Given the considerable underfunding of the Braniff pension plans and the fact that the PBGC may be unable to recoup any assets from the bankrupt carrier, such a termination would impose considerable burden on PBGC.

In its annual report for the year ending September 30, 1981, the PBGC stated that it suffered losses of $140.6 million in its single employer programs last year, a 434.6 percent increase over the previous year. This loss resulted in part from the net claim of $58.3 million attributable to the pension plans of the bankrupt White Motor Co. The termination of Braniff's pension plans would impose a massive future liability on the PBGC resulting in a loss equal to or greater than the loss suffered as a result of the White Motor bankruptcy.

If ERISA and the PBGC are to function as an effective safeguard for the vested pension rights of American working men and women, action must be taken by the Congress to permit the PBGC to insure adequate funding for its current liabilities as well as funding for future pension plan terminations such as those covering the employees of Braniff. In this regard, the IAM fully supports the request of the PBGC for authority to increase the premiums for its pension plan liability insurance.

Thank you for permitting me to address to this Select Committee the concerns of the IAM on this very serious problem.

The CHAIRMAN. Thank you, Mr. Scheri, for an excellent statement.

Did your associates wish to add anything by way of a direct statement?

Mr. SCHERI. No, Mr. Chairman.

The CHAIRMAN. Mr. Jones?

STATEMENT OF EDWIN JONES

Mr. JONES. Good morning, Mr. Chairman and members of the committee.

With me today are Henry Rose, our general counsel; Gerald Cole, our assistant executive director for policy and planning; Mr. Lawrence Maslan, director, Office of Financial Operations; and Mr. De-

Harde, Director, Office of Program Operations; and others on the staff, including John Hirschmann, in the event we get into any detail.

I have a prepared statement which I would ask be entered in the record. I would just like to talk to you about the problem as I see it today.

The CHAIRMAN. You have a written statement?

Mr. JONES. Yes.

The CHAIRMAN. Without objection, it will appear in the record.

Mr. JONES. I would like to just present to you three of the basic things that we are looking at in terms of the present scene. It relates to our premium increase in the first place. I would like to just explain some of the background on that.

First of all, we have to look at the past claims that have been projected or have in fact occurred over the previous years and those that are going to be occurring in the future. First, as to past claims, during the years through early 1977, we averaged about $25 million in net claims a year. That is the amount of claims that were incurred by the system, representing the amount of the unfunded liability that we are required to assume.

Now these claims jumped very sharply, in the next 5 years up to the present time, from 1977 through 1982, and they jumped from an average of $25 million to $62 million a year. Now, that is a two and a half times increase which we are well aware is an important increase.

Because of that, we wound up with a deficit of $189 million as of the end of fiscal year 1981. That is September 30, 1981. That deficit, at our present premium level of $2.60 in the single employer plan program is estimated to increase to $236 million by the end of 1982. That represents, in effect, a loss which PBGC incurred when we assumed the liabilities under these plans. Now that is where we are.

Now, in a typical insurance company, Mr. Chairman, this kind of a loss would not be occurring because insurance companies would not sell policies in the first place at a loss. So, we take that liability and we book it as something that we have got to discharge.

What we would like to do and what we have asked Congress to do is to increase the premium from $2.60 to $6. Of that increase of $3.40, $2 represents an amount which will, over a 5-year period, discharge the loss we have already incurred. That will bring us current at the end of 5 years for the claims through 1982 as we project our figures.

Now, looking forward—it is really the first basic element that we have to contend with. We want to get to a solvent position, a fiscally prudent position for a corporation like ours which, on a broad conceptual basis, basically, is an insurance company promising to pay annuities.

The second element is what is going to happen in the future. It is difficult to project what is going to happen in the future. But certainly taking our claims over the past 5 years, and before that, we see a straight line progression that shows very sharp growth in the area of 9 percent a year over a period of years. That projects out to average claims over the next 5 years of about $97 million a year, roughly speaking. Therefore, we are projecting claims of $500 million—$470 million to be more precise—over the next 5 years.

Now, that amount of money has to be produced in order to keep us fully funded. We have at the present time roughly 28 million people from whom we are receiving premiums. We are expecting an increase to about 32 million participants. So we take the 32 million participants and we get a $3 premium per person, that is going to produce a figure that is our expended total claims of $96 millon. And it is that figure of $3 which is part of the $6 requested premium which is for claims that we fully expect or project to incur.

So you have got $2 to begin with from the losses we already have to put us back in what we would consider to be a fiscally prudent situation, and $3 to cover additional claims.

Now, the remaining dollar of the $6 is for administrative expenses, which now approximate $26 million, and we estimate we are going to need about $32 million a year average over the next 4 years. So that is the other dollar of our expenses.

In connection with the administrative expenses, we have a large amount of claims that have to be processed by us that don't result in our paying benefits. There has been some criticism of the administrative expenses, which we continually look at, and I will look at as the new executive director. Basically, we do have a substantial amount of duties that have to be performed to implement the congressional mandate to us, and those things don't produce any benefit payments. It is just work, time, effort. So people criticize us because they say our expenses are high in relation to our benefit payments. We don't think so in relation to the jobs we are doing for Congress that, hopefully, never produce benefit payments because the plans processed have sufficient assets to pay benefits under title IV.

As a matter of fact, looking over many years to come, we would like to get to the point where we have nothing but administrative expenses and, hopefully, the system would be so sound we wouldn't have to make any payments. In that case, you would have an infinite percentage of expenses to benefit claims. So we consider our administrative expenses quite reasonable, in light of various comparisons we have made, and could supplement them more fully.

Now, the third aspect on the scene that we look at is what is going to happen in the future beyond what we projected. We do have an assumption of $500 million or an average of $96 million per year over the total 5-year period. We state in our proposal to Congress that that does not take care of any unprecedented large claims. Well, that is true, we have not factored into our calculations any large termination beyond those that would come in within roughly $100 million a year.

The CHAIRMAN. Does that include Braniff?

Mr. JONES. Well, athough Braniff may turn up at $62 million, as the gentleman from Braniff said, we have not received a notice of intent to terminate. We have been in touch with the company as we are with many of these companies, and we would calculate that the claim is perhaps in the area of $60 to $70 million for the total Braniff situation, all its plans. That assumes certain interest rates are going to be used and calculated in the amount of the benefits. And there are various ways of treating the problems in these underfunded situations and, over many years, I have been involved in a lot of them. Sometimes the figures that appear to be where you are in the unfunded situation don't actually eventuate.

Bear in mind that we are very, very concerned and we are very much aware of the figures that may emanate and the ranges that are involved. Our figures which reflect certain adjustments to guaranteed benefits, which would be below the levels that are accrued under the plans, could be considerably lower under various assumptions.

The CHAIRMAN. Would you be able to pay the pension obligations of Braniff?

Mr. JONES. I don't think there is any question about that in terms of our present projections, provided two things: First of all, all of the assets come over to us that are now in the present Braniff plans; and second, that we would get an increase in the premium from the present $2.60 to an area approaching the $6 side. If we don't get the increase, there will still be, on a cash-flow basis, money coming over from the Braniff plan that would enable the payment of benefits for a period of time.

That is not what we are banking on in terms of projecting our premiums.

The CHAIRMAN. Do you have any responsibility in respect to health insured plan?

Mr. JONES. Mr. Chairman, we do not.

The CHAIRMAN. Go right ahead.

Mr. JONES. We have those projected throughout——

The CHAIRMAN. It has been intimated if not said that if you had one or two other large failures, you might be stretched to the limit of your means or even beyond.

Mr. JONES. We are aware of various statements that have been made. We have made various computations and placed companies in high risk categories and moderate risk and we come up with a figure of potential claims that might fit into the $3 to $4 billion area.

That is on fairly conservative interest assumptions. In fact, the figure might be somewhat lower, but our calculations indicated, Mr. Chairman, that for every $1 billion we would have to increase the premium approximately $6 or $6.50 or thereabouts, above whatever level it is in at that time, so that if we are talking about $1 billion that would hit us and one can speculate on this of course, but realistically, I don't know that we would project receipt of all of $3.3 billion in claims from 33 or 34 plan sponsors.

Most of the companies we might think of, are using various measures in the risk area. It would certainly be unlikely we would receive all of those claims at one time. Even if we did and tried to fund it in a fiscally prudent manner like any insurance company we would be talking about getting about $6.50 per participant a year to fund that deficit over 5 years so on a $3 billion increase——

The CHAIRMAN. May I interrupt you again, Mr. Jones.

Do you have enough assets to meet your obligations which have already accrued from the many bankruptcies which have occurred in the country in the last year or two?

Mr. JONES. Mr. Chairman, as of the end of last year, we had approximately $526 million of assets against $715 million of liabilities that have accrued—we should understand the accrual is the present value of a stream of benefits over many years and we take that stream of benefits that would be payable over the lifetime of a person, depending upon the age, and we will translate that back into a present-value figure.

When we talk net claims we are talking about the present value of a stream of payments to be made over a period of years in the future. Now, it is that figure that produces the $189 million deficit as of the end of last year. The difference between our assets of $526 million and our liabilities of $715 million or thereabouts.

The CHAIRMAN. You have spoken about increases in contribution. Are you anticipating those increases would be retroactive?

Mr. JONES. No, sir.

The CHAIRMAN. How would you make up for the deficit?

Mr. JONES. The deficit is going to be made up out of $2 of the present proposed $6. That $2 would produce an amount of money that will over a 5-year period retire that total deficit of $189 million as of the end of the year 1981, projected to rise to $236 million as of the end of 1982, so the answer to your question is that $2 will produce per participant an amount of money that will put us even 5 years out and we'd have no loss, assuming the rest of our projections work out.

The CHAIRMAN. What if a company goes bankrupt after they begin to pay that $2 additional premium, do they continue to pay it?

Mr. JONES. It continues to be a liability, Mr. Chairman, until the plan is completely liquidated.

The CHAIRMAN. Suppose the company voluntarily terminates a pension plan, what happens to our $2?

Mr. JONES. Well, it is going to cease pretty soon. Have we any record on that? Mr. Maslan, do we have any indication on what has happened in the past on that?

Mr. Maslan is the director of our Office of Financial Operations.

Mr. MASLAN. The plans upon termination continue to pay until such time as they become trusteed by the PBGC or their assets are distributed under a notice of sufficiency. Now, plans that are terminated are always replaced based on history by new plans that have been formed. Therefore, our premium base has been increasing over a period of years and we projected all these factors into the calculations we made when we came up to the $6 premium so that we are concerned with a total premium base and how much income will be produced when that is multiplied out by the $6 per participant as that will produce the premium we deem necessary to cover our funding shortfall.

The CHAIRMAN. It seems to me every time a company goes broke you lose a base of contributions.

Mr. JONES. Unless it is replaced by some other plan which we are going to insure, that is correct. It ceases as soon as we take over the plan. That may be down the line. It varies in various cases. For instance, if a company goes bankrupt or files for bankruptcy, it may not terminate its plan for a considerable period of time.

The premiums would continue to be paid during that time. It is only upon liquidation and then trusteeship by us, that the premiums would cease.

The CHAIRMAN. Have you requested any direct contribution, a direct appropriation to you, rather than Congress levying an obligation on employers to require larger contributions?

Mr. JONES. No, we have not, Mr. Chairman.

The CHAIRMAN. You may proceed.

Mr. JONES. Now, coming to these projected claims that may occur, we have been concerned for a considerable period of time about the ways in which the law now operates so that claims can be placed upon the PBGC. We are concerned about the cases where there is a transfer by a company to another company, or a spinoff of a division or subsidiary with very limited assets and as a result, after the spinoff the plan is terminated and then 30 percent of the net worth of that spunoff company is less than the amount that we have to incur.

That is something that we are well aware of and have testified—the administration has already testified in support of that through Mr. William Niskanen of the Council of Economic Advisers.

We also have testified in favor of changing the status of our claim from that of a priority claim for 30 percent of net worth, which can often be zero, to a claim to general-creditor status. That has been strongly urged by the administration. We are now and have previously testified before Senator Nickles in connection with that very matter, so that we are fully aware of the possible abuses of the present law and would hope to have them plugged and are urgently supporting that change in legislation, Mr. Chairman.

The CHAIRMAN. Of course, what we are all concerned about is whether or not the beneficiaries, the 28 or 29 million—and you say they will reach 32 million—of pension plan participants in this country, may rely upon the pensions they have relied upon. You can understand how important that fact is to all those people.

What can you say in general about that?

Mr. JONES. We share the same concern that you have, Mr. Chairman. We believe on the basis of our present projections that if we get the increase in premium from $2.60 to $6 we will have as sound a system as any large insurance company in this country can be. I say large, but we are not that large; we are only really in the small category yet with $700 million of assets.

The CHAIRMAN. Mr. Jones you recently appeared before Senator Nickles, chairman of the Labor Subcommittee of the Human Resources Committee of the Senate. Senator Nickles indicated that he would be unwilling to support your request for a premium increase from $2.60 to $6 unless certain changes were made in the way PBGC administers its benefits.

Would you kindly briefly describe the Senator's concern and describe what would happen if the PBGC doesn't get a premium increase?

Mr. JONES. If we don't get a premium increase, our projected deficit will rise considerably from the present projected level of $236 million by year end. Our figures would indicate that the deficit would increase to something like $470 million by 1986, I believe is the correct figure—I might ask Mr. Hirschmann to verify that; is that correct, Mr. Hirschmann?

Mr. HIRSCHMANN. Yes.

Mr. JONES. To $470 million, if that increase is not granted.

From the point of view of the individual who is concerned about having these benefits guaranteed, one should keep in mind on a cash basis we have assets that are in the area of something over $500 million now.

Now on simply a cash basis of being able to make benefit payments against our assets we have amounts of money that would be utilized to pay those benefits. On strictly a cash basis, which is not what we think is the proper way to run a fiscally prudent operation, you would be able to pay benefits for many years.

The CHAIRMAN. What has been the initial complaint or question about your present way of administering benefits?

Mr. JONES. I guess he would be the best one to answer that but since his comments, and I hesitate to speak at all for him, Mr. Chairman, but my understanding is that there was an assertion made by the American Society of Actuaries, that we were spending 89 cents for every dollar of payment in administrative expenses and that that was too high a ratio.

In my prior testimony, I refer to the fact that we have a very large amount of responsibilities to discharge that are completely unrelated to payments and those are duties imposed upon us by Congress.

For example, we have had some 33,000 plans terminated since inception. Of that, 32,400 had sufficient assets. Now, those 32,000 plans will not produce any payments. It is totally irrelevant in our view to be arguing that the administrative expenses are high because they represent a percentage of payments.

Payments is not the correct measure. We don't think it is a valid complaint. That is about the best I can do on that particular matter. We are looking at $5 administrative expenses. As I say, I am new on the job, and I am looking them over but I don't think that is a serious matter.

The CHAIRMAN. You construe that your duty is that of policing the system and you say for all the services that you render, the administrative expenses you have incurred are not excessive?

Mr. JONES. That's correct; we certainly do not think it is.

The CHAIRMAN. Very well. Thank you very much, Mr. Jones.

[The prepared statement of Mr. Jones follows:]

PREPARED STATEMENT OF EDWIN M. JONES

Good afternoon, Mr. Chairman and members of the committee. I'm Edwin M. Jones, executive director of the Pension Benefit Guaranty Corporation. With me today are: Lawrence Maslan, director, office of financial operations; Henry Rose, general counsel; Gerald E. Cole, Jr., assistant executive director, office of policy and planning, and John Hirschmann, chief, division of financial and actuarial program development.

I'm pleased to be able to testify before you today and I'm looking forward to working closely with the Congress to ensure a sound guarantee program for the retirement benefits of American workers.

The corporation, wholly-owned by the United States Government, protects participants in both multiemployer and single employer defined benefit pension plans against loss of their basic pension benefits. This program insures the benefits of about 28 million participants in single employer plans and 8 million participants in multiemployer plans.

The PBGC is currently making payments in the single employer program to slightly over 39,000 participants, in an amount which totaled $57 million in fiscal year 1981 and may approximate $75 million in fiscal year 1982. The PBGC has also assumed responsibility for the payment of deferred vested benefits to an additional

31,000 people. The insurance program is financed exclusively by premiums paid by sponsors of covered plans and by income on its investments.

The single employer pension plan insurance program needs Congress' attention in a number of areas. Our primary concern today is the inadequacy of the current premium of $2.60 per participant. We have proposed that Congress increase the annual premium to $6.00 per participant, in order to allow the PBGC to meet future benefit claims as they arise, and to retire the growing deficit.

The PBGC began insuring basic benefits in single employer plans in September 1974. At that time the premium was $1 per participant. By September 1976, the PBGC's deficit had risen to $41 million. Late in 1977, Congress increased the premium to $2.60 per participant effective January 1, 1978. The PBGC expected the 1978 premium increase to fund the program adequately through 1981. As of September 1981, however, the single employer plan program had a deficit of $189 million, over four times the deficit in 1976.

The growing deficit reflects larger than expected claims against the PBGC. By "claim", I mean the obligation to pay benefits that the PBGC assumes when an underfunded plan terminates, less what the PBGC gets back. The amount of a claim is measured by computing the present value of the PBGC's promise to pay benefits that will come due over a period of years, and subtracting the sum of the plan assets that the PBGC takes over and the liability payments the PBGC recovers from the plan sponsor.

In the last 4½ years, claims against the PBGC increased to an annual rate of $62.3 million, up from the $24.7 million annual rate during the first 2½ years of the PBGC's existence. The current average claim against the PBGC is $1 million, compared to just under $300,000 at the time of our last premium increase request in 1977.

Approximately one third of the requested $6.00 per participant premium request is designed to retire the present deficit by 1987. I believe that the responsible way in which to manage the PBGC is to attain a current funding status for the single employer insurance program as quickly as possible, consistent with reasonable premium levels. The PBGC should have on hand, at any point in time, assets which, together with the expected return on investment, will be sufficient to fund all liabilities that then exist.

The PBGC projects that if the premium is not increased, the deficiency in assets will continue to grow. By January 1, 1983 (the date on which the PBGC recommends that the increase be effective), the deficit is expected to reach $236 million. If the premium is not increased, we project that by the end of 1986, the deficit will grow to nearly $470 million. However, if the premium is increased as requested and if past experience continues, the deficit should be eliminated at the end of 1987.

In addition to the need to retire the existing deficit, the present premium needs to be substantially increased to fund the claims the PBGC will receive over the next five years on a current basis—that is, without adding to the deficit by the end of 1987. On the basis of our actual claims experience, it is expected that claims will increase at about $8 million per year in the future. This upward trend in PBGC claims reflects a number of factors, including an increase in the amount of plan benefits to participants and an increase in the number of participants in plans that have terminated. While benefits have been increasing, assets of terminated plans taken over by the Corporation have remained a relatively constant percentage of total guaranteed benefit claims. Thus, the amount of underfunding per participant increases as benefits are increased. There is nothing different in concept in these increases in benefits from other components of the total compensation package, such as wages, welfare benefits, and the like, all of which have been increasing in dollar terms to maintain compensation levels. Therefore, we have no doubt that the PBGC's claims will continue to rise.

It is important to note, however, that the $6.00 premium will not create a reserve for possible claims, larger than any we have had so far, which may develop from the termination of a relatively small number of very large plans. By reviewing corporate annual reports, the PBGC observed that corporations with the 50 largest unfunded vested liabilities had unfunded liabilities of approximately $15 billion. The smaller unfunded liabilities of other publicly traded firms totalled another $4 billion.

To set aside a reserve of one billion dollars over the next four years, the premium would have to be increased to $12.64 per participant effective January 1, 1983. However, the PBGC has chosen not to ask Congress for such a premium level at this time. If such large claims actually occur, plan assets on hand at termination, as projected by the PBGC, will probably be adequate to pay guaranteed benefits for a sufficient length of time to permit the PBGC to seek any necessary premium increase.

Nevertheless, the threat of such extremely large claims makes it all the more important to retire the present deficit and have the PBGC currently funded by 1987.

In addition to the premium increase, the administration is supporting certain legislative changes which are essential to the health of the single employer plan termination insurance system.

Recently, the PBGC has incurred about $50 million in claims in cases where companies sold or spun-off weak subsidiaries or divisions and transferred pension liabilities pursuant to the sale or spin-off. Under current law, the employer is liable to the PBGC for the value of unfunded guaranteed benefits on the date of plan termination. Employer liability may be enforced against all affiliated companies which are part of the same controlled group, up to 30 percent of the net worth of the employer and its controlled group.

The risk to the PBGC exists because after the transfer, the financially weak spun-off company or purchaser is often unable to continue the plan. At temination, the PBGC has lost its claim against the company that would be liable but for the sale or spin-off. Thus, the "employer" at the time that almost all the pension liabilities accrued is free of liability. The purchaser, who is liable to the PBGC, often has little or no net worth from which PBGC can recover.

Title VI of H.R. 4330, the Retirement Income Incentives and Administrative Simplification Act of 1981, introduced by Congressman Erlenborn, recognized the dangers to the single employer plan guarantee program if this transfer loophole is not closed. It provides that if a plan is transferred from one employer to another after enactment of the bill, the prior contributing sponsor, and each trade or business in common control within the five years preceding the change, would be jointly and severally liable to the PBGC if the plan is terminated within 15 years of the transfer because of the new plan sponsor's liquidation.

Title VI of H.R. 4330 would also redefine the insurable event. Under present law the insurable event is the termination of the pension plan, an action which can be taken voluntarily. H.R. 4330 would make the liquidation of the sponsoring employer the insurable event. The administration supports this change to remedy a serious abuse of the system which occurs when ongoing companies with relatively low net worth attempt to terminate their plans, taking advantage of the limit on employer liability to reduce their liability to the PBGC while continuing in business with no pension costs.

PBGC has identified 30 major firms, each with unfunded benefits of $10 million or more that are under financial pressure and for which payments of 30 percent of net worth could be an attractive alternative to the continued funding of their plans. If all of these firms were to terminate their plans, PBGC estimates it would suffer 3.1 billion in losses. The redefining of the insurable event from plan termination to liquidation of the sponsoring company would prevent ongoing businesses from "dumping" their pension liabilities on the PBGC.

I thank you for the opportunity to testify, and we would be pleased to answer any questions you may have.

The CHAIRMAN. Now, Mrs. Munnell, you recently wrote an article estimating the Braniff pension plan liability would be far in excess of what Mr. Jones has estimated today. Can you comment on the adequacy of a $6 premium to help the PBGC cope with the Braniff collapse, as well as the collapse of other major corporations.

Ms. MUNNELL. My estimate of the Braniff liability was based on the figures in their 1980 report. At that time I think they calculated their liability using a 7- or 8-percent interest rate. Since that time, interest rates have increased substantially and in the same article I did an exercise that showed the impact of higher interest rates on the Braniff liability.

Of course, at the same time Braniff's net worth has probably gone down. On balance, however, it does not seem to me at all unreasonable that the net liability is now $60 to $70 billion, not $130 billion, as you would have thought by looking at the 1980 annual report.

I think there is no question that PBGC needs a rate increase to $6 per participant. I agree with everything Mr. Jones said about the administrative expenses.

The CHAIRMAN. Do you agree if he got the $6 increase he would have adequate funds to meet his anticipated obligations?

Ms. MUNNELL. I think if I were trying to calculate an annual premium, I would have done it in the same way that the PBGC did it. All you can do is project past experience. I think the staff of the PBGC is as aware as I am that there is a risk and it is important, I think, that Congress and everyone be aware of the risk so if the agency needs to come back for more money it does not mean that they have been imprudent at this time.

The CHAIRMAN. Will the requirement that the amount to be contributed by an employer increased from $2.60 per person covered to $6 (1) endanger the financial stability of that employer, or (2) makes that employer inclined to terminate the system rather than to perpetuate it?

Ms. MUNNELL. You certainly hear from employers that they are resistant to the increase from $2.60 to $6 per participant. However, PBGC contributions are still less than 1 percent of annual pension contributions even at the $6 level. As the rate goes up, however, I think you are going to find increased resistance from well-funded plans to help subsidize underfunded plans and I think you may run into problems with the simple person-participant rate structure. You may need some form of risk-related structure which makes your problem worse because that means the weaker plans will be the ones paying the higher premiums.

The CHAIRMAN. Is that the main recommendation you would make that in other words to make adequately secure a private pension system and systems of the company, we adopt Mr. Jones' recommendation, would that be your major recommendation to the Congress?

Ms. MUNNELL. No, I think there are three other equally important recommendations. One, I think you have to close the loopholes for potential abuse. This means I think you have to eliminate the option for companies to voluntarily terminate their pension plans and setting up IRA's. I think that is essential. I do not think PBGC can continue if that loophole exists.

Second, I think something has to be done about strong companies who spin off weak subsidiaries with large, unfunded liabilities. The parent company has to be held responsible for that so the burden does not end up in the lap of the PBGC.

My third recommendation is based on the conclusion that establishing employer liability as a percent of net worth is not rigorous enough. Net worth in the case of a bankrupt company clearly approaches zero, so the PBGC can be left with nothing. It does not seem rational that the PBGC has lowest priority in terms of claims. I would definitely elevate the level of claims, so that the PBGC has a claim on corporate assets rather than corporate net worth.

The CHAIRMAN. What would be your reaction to mandatory, universal, in the sense of all employees being covered by pensions. Mandatory meaning the requirement that they be covered and it be mandatory they be covered.

Ms. MUNNELL. I am not quite as enthusiastic about that proposal as Tom Woodruff is, but I have great concerns in this environment when people are talking about reducing future replacement rates under social security. I think that would be an impossible thing to do under the current system where some people have supplementary private pension coverage and others are totally dependent on social security.

If we are going to at all talk about cutting back on social security we will have to establish a mandatory, universal pension system.

The CHAIRMAN. I didn't quite get your point. If you say it would be undesirable to have a mandatory private pension system.

Ms. MUNNELL. The environment that I see is one where substantial pressure develops to cut back on the levels of protection provided under social security. I think that that is a terrible thing to do, given the current private pension system where some people are covered and others have no supplementary source of retirement income.

If we are at all going to reduce the role of social security then we are going to have to establish a mandatory universal pension. In that environment, therefore, I would certainly support your proposal.

The CHAIRMAN. What, according to your information, would be the percentage of retirees in our country, today, private retirees, who are covered by a pension system?

Ms. MUNNELL. Twenty-two percent of people 65 and over are currently receiving private pension benefits. An additional number of people receive benefits from State, local, and Federal programs.

The CHAIRMAN. We have been using the figure 25 percent max. Do you think it would be nearer 22 percent?

Ms. MUNNELL. The data I looked at were for 1979.

The CHAIRMAN. That accentuates the importance of the one mandatory system we have. Social security being maintained, and social security benefits being preserved and stabilized, does it not?

Ms. MUNNELL. I couldn't agree with you more, Mr. Chairman.

The CHAIRMAN. Good for you. Thank you very much.

Now, one question, Mr. Scheri. Presumably, PBGC will offer some protection to Braniff employees. I believe Mr. Jones has indicated you are going to offer full protection, which gratifies us immensely to know that, for those people who are anticipating release of pension benefits.

If Braniff's collapse weakens PBGC, what is the outlook for protection to be provided to employees of other companies?

Mr. SCHERI. Mr. Chairman, we are very concerned about that. I guess the best way I can answer it is, it is unfortunate about Braniff, but this may be the start of something within the air transport industry. There are other similar pension plans that are less underfunded and we are very deeply concerned because, on Braniff, for example, the average seniority right for pension credits is around 25 years, the senior guy being 44 years.

And never realizing a pension at this point, we are very concerned that PBGC has appropriate funds to provide the benefit for the people who worked so hard, be it Braniff or any other carrier.

We have no other protection, Mr. Chairman.

The CHAIRMAN. Was Braniff a company where the employer made all the contribution or did the employees participate?

Mr. SCHERI. It became a noncontributory plan if my memory serves me right, going back to 1969.

The CHAIRMAN. How many employees did Braniff have covered by this plan?

Mr. SCHERL. Over 9,500.

The CHAIRMAN. Nearly 10,000 people in this country, most of them, representing an individual family. Like the husband of the lady who has been working for me in Miami. He was an airline captain until he retired at age 62. Now, here he is terribly frightened as to whether or not he is going to get any retirement benefits in the future.

So it is a cruel thing to perpetuate upon these people who go along for years relying upon getting a pension when they retire and then to find that somebody has not made provision or assurance that they will get that pension.

What a cruel hoax it is upon those people who don't get it. It is our job to create a system under which they will get it. By insurance, or something, assets that will be available, but not to let these people who have relied for their working years on this, until they come to time of retirement, or people who have paid in almost enough to vest their pension and then not get anything, because the employer economically collapses.

We are concerned with the overall protection of sort of an implied obligation of goodwill and faith that we have given to these people, they think they are living in a country where somebody will see to it that they will get what they had a right to expect.

That is why we are holding these hearings.

The staff has proposed this question, Mr. Jones: Would you oppose any reduction in all of the various protections ERISA offers plan participants as a part of the legislation to increase the premiums?

In other words, would you propose Congress reduce the extent of your protection and the extent of your duties in connection with your request for larger contributions per capita?

Mr. JONES. Mr. Chairman, we have not so proposed to date—I would point out just to keep this in focus—that our maximum guarantee is a total of $1,380.68 a month, and above that, we have no congressional authority to pay benefits.

Now, we could go above that figure in certain circumstances although I believe the figures I have been shown indicate that it seldom, if ever, goes above that figure for retired people who may have been receiving more than that prior to termination.

No. 1, in answer to your question, I would say we have a limit on it and we haven't proposed the guarantees be changed.

The second part of the answer to your question is—and you may be referring to assertions that have been made that the PBGC has included within the classification of covered benefits certain early retirement and other benefits vested under a particular plan, and as to that, it is something that was given very serious consideration back in 1975 and 1976.

There were hearings widely held on that matter and there was a lot of attention given to it. There are now comments to the effect that they really shouldn't be included within the guaranteed level of benefits and I am looking at that, but in the light of what I have seen there was a very extensive study made, legal views obtained and I know of no steps——

The CHAIRMAN. Mr. Jones, by asking that question, I didn't mean to indicate any opinion on my part that you should reduce your protection. I remember very well what led up to the adoption of the ERISA program and we relied upon your agency being representative of the Congress and the country to see to it that this program was properly and adequately administered.

People were protected in case they moved from one employment to another, before the vesting period occurred and the like, so if you need any more authority to do a good job to protect the people and the public interest, I would be in favor of granting it.

I want you to know we are not complaining. Somebody has to do it, and it looks like you are the agency chosen by the Congress to do that.

Mr. JONES. We plan to do that.

The CHAIRMAN. Mr. Hammerschmidt?

Mr. HAMMERSCHMIDT. Thank you, Mr. Chairman. You have pursued this subject matter quite diligently and asked many of the questions that are on our minds. I would like to follow through with a couple of brief questions.

Mr. Scheri, there has been a discussion in the media about the possible merger of Braniff with Pan American Airways. It is my understanding Pan Am, like Braniff, has a relatively large unfunded liability in its pension system.

If this were to take place, what impact do you believe it would have on the solvency of the company's pension plan or on the PBGC?

Mr. SCHERI. I think it would have an immediate impact, Mr. Congressman. No. 1, Pan American is just coming through a merger, it is only a couple years old, with National Airlines.

You are correct, their unfunded portion at this point runs around 23 percent. As far as the merger is concerned, I haven't heard about it in that context other than what has been publicized in the news media.

They are thinking about picking up some of the Braniff crews and routes and so forth. We are on the side of that situation, because we are a participating organization on the credit committee. I haven't heard the word merger at this point, but I understand your anticipation if it comes about.

There would be an immediate impact which could possibly result in the collapse of another carrier, in my professional opinion.

Mr. HAMMERSCHMIDT. Mr. Jones, would you care to comment on the effect on the PBGC of a merger of this kind? I realize we are speculating at the moment.

Mr. JONES. In neither case have we any indication they propose to terminate their plans, Mr. Congressman, but as I indicated before, we are conscious of possible developments and are endeavoring to keep abreast of things as rapidly as they occur, to the extent of the facilities available to us.

I can only point out that if there is a merger, there would have to be a provision made for plans. If, in fact, there is a merger of assets of one plan to another, the law requires in section 209 of ERISA and section 414 of the Internal Revenue Code that the rights of the participants immediately after the merger of plan assets be no worse than they were immediately before, so that there are certain built-in safeguards into the law at the present time that deal with that problem in order to allow participants to retain exactly what they had before, after the merger.

Now, so far as the economic effect of the merger is concerned, I am completely unable to comment on that. Obviously, if the merged companies are better able to continue the plans than before, then it is an improvement from our point of view, and the less likelihood there would be a termination.

If, on the other hand, events turn out otherwise, then we would be facing a situation that would involve the unfunded liabilities of both Pan Am and Braniff.

Mr. HAMMERSCHMIDT. Thank you, Mr. Jones.

Mr. Jones, I noted in earlier testimony that Mr. Priest stated the PBGC has power to initiate an involuntary termination to protect itself and plan beneficiaries while the sponsor still has some net worth.

Has the PBGC exercised that option, and if not, I wonder why not?

Mr. JONES. That is something that we are aware of. That is something that is currently being looked into. In the past, there have been, I believe, two actions related to that matter. I would ask Henry Rose, our General Counsel, to comment on them, if he would.

Mr. HAMMERSCHMIDT. Have you ever exercised the option?

Mr. ROSE. Yes, sir, we have attempted that in two cases. One of them was settled without a judicial decree. The other resulted in a decree which did not result in a retroactive termination.

That is to say the court granted our involuntary termination, but as of the date of the decree, rather than as of the earlier date of our filing, so that the effectiveness was somewhat questionable.

Mr. HAMMERSCHMIDT. What company was that?

Mr. ROSE. That was a steel company, Heppenstall.

Mr. HAMMERSCHMIDT. Why have you not initiated involuntary terminations more often?

Mr. ROSE. It didn't turn out to be very effective in the one case we used it in and more importantly, it puts us in a very delicate position.

Many times those companies are in the throes of trying to reorganize and come out as a viable company. If we go in too soon, we are undercutting that effort. If we wait too long we may lose out on some of the assets, so there is a very fine line on what is the right time to move.

Mr. HAMMERSCHMIDT. Thank you.

Mr. JONES. For example, in the past there was more concern about Chrysler than there is at the present time. If I read the paper correctly, and if we participate in action of that kind, it affects a lot of people, and from an equitable point of view, from the point of view we are looking at it, we are conscious of competing rights and interests, here, and it is a difficult question to move prematurely on.

Mr. HAMMERSCHMIDT. Thank you very much for your response. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Hammerschmidt.

Ms. Munnell, Mr. Jones, and Mr. Scheri, those who accompanied you, we appreciate very much your valuable contribution.

[The following material was subsequently received from Mr. Jones in response to written questions submitted to him by the chairman.]

PENSION BENEFIT GUARANTY CORPORATION,
Washington, D.C., August 19, 1982.

Hon CLAUDE PEPPER,
Chairman, House Select Committee on Aging,
Washington, D.C.

DEAR MR. CHAIRMAN: Thank you for your kind letter of July 7 regarding my testifying before the Select Committee on Aging.

As you requested, enclosed is my response to the list of questions you submitted with your letter. I apologize for the delay; however, the list was lengthy and some of the information was not readily available. I do hope they are answered to your satisfaction.

Again, I would like to thank you for the opportunity of appearing before our Committee. If you have any further questions, please let me know.

With kindest regards.

Sincerely yours,

EDWIN M. JONES,
Executive Director

Enclosure.

Question 1. The Corporation projects for Fiscal Years 1981–1986 a total of $1,62 billion in deficits for those 5 years. (See PBGC Fiscal Year Annual Report pp. 39–40) Will the Corporation's present premium request of $6.00 alleviate this deficit or will the increased likelihood of prospectively larger claims require an increase beyond the $6.00 premium request?

PBGC response. The deficit amounts presented on page 40 of the Fiscal Year 1981 Actuarial Report are cumulative amounts, not individual annual amounts, and the cumulative deficit for the first 5 years (1981-1985) is $1.4 billion. Accordingly, at the current premium rate, the Corporation anticipates a deficit of $448 million as of September 30, 1986. The $6.00 premium is expected to retire the existing deficit by December 31, 1987.

Question 2. These projections assume that there will be no claim in excess of the largest one to date, that of White Motor Corp. for $60 million. What would be the financial impact on the Corporation if International Harvester went into bankruptcy and terminated its pension plans? What will be the effect on the Corporation if a termination of the pension plans of Braniff Airlines occurs?

PBGC response. The guaranteed unfunded vested liabilities of International Harvester's plans are estimated by the PBGC to approximate about $375 million at PBGC rates. A comparable figure for Braniff's plans approximates $60 million. These figures depend upon a number of assumptions which can only be verified if the plans are terminated, and we do all the necessary calculations on the basis of full factual knowledge. The assets of these plans are substantial. We are in contact with these companies and are considering in detail how best to proceed.

Braniff's termination would present no serious problem to the PBGC. International Harvester's termination would be of much concern. In view of available plan assets, however, there would be no immediate net worth drain in the PBGC. We would have to assess all the facts at the time to determine whether a premium increase would be sought.

Question 3a. In her recently published study, Alicia Munnell has identified 86 companies whose unfunded liability exceeds 30 percent of their net worth. These companies, according to this study, represent a potential liability of $4 billion to the Corporation. How does the Corporation proceed in identifying companies and those plans that are likely to terminate?

PBGC response. The Corporation monitors the Compustat data base of nonfinancial publicly-traded firms. This data base is screened for firms with unfunded vested liabilities (UVA) in excess of $10 million. These firms are assigned to risk categories based on information such as bond ratings, Z-scores (a bankruptcy projection indicator), Value Line, and stock prices.

Question 3b. How does the Corporation's projections or knowledge of companies in danger enhance the agency's ability to carry out its mission?

PBGC response. By monitoring these firms, the Corporation can 1) gain valuable knowledge on the causes of plan termination, 2) make contingency plans for the possibility of large plan terminations, and 3) improve the reliability of forecasts of large plan terminations, and 4) consider involuntary termination by the Corporation under Sec. 4042 of ERISA.

Question 3. Does PBGC see an "incentive" for plans to terminate given the 30 percent limit on net worth that it can receive when single-employer plans terminate?

PBGC response. Yes, whenever the excess of the present value of the plan's guaranteed benefit liability over the market value of the plan assets is greater than the statutory liability (30 percent of sponsor net worth).

Question 4. Many of the Corporation's claims come from mature industries such as the steel industry, e.g., Alan Wood Steel, Wisconsin Steel and McLouth. Does the Corporation expect claims from such industries to increase or decrease in the future?

PBGC response. The PBGC has attempted to relate both the frequency and value of net claims to past economic activity. Because our net claims are primarily caused by business failures, one can say with some assurance that a relationship exists between our claims experience and the economy of the country. We expect the number of plan terminations to decrease as the economy of the country continues to improve. As a result, employment is expected to increase along with production and profits, and see a decrease in the number of plan terminations in most industries, including the steel industry.

Question 5. Does the Corporation attempt to engage in long-range forecasting (10-20 years from now) as to the possibility of plan terminations?

PBGC response. The Corporation only forecasts plan terminations for five years. This is done in connection with the Actuarial Report which is published in the PBGC's Annual Report. The Corporation's claims history is only eight years; therefore, a good data base for long-range forecasting (over five years) does not exist. This matter will be considered further.

Question 6. How did the Corporation arrive at a figure of $6.00 for its proposed premium increase for single employer plans? (Brief explanation.)

PBGC response. The Corporation projected 1) the cost of its future claims based on its past experience. This approach adjusts for the fact that benefits are increasing, 2) the cost of retiring its current deficit ($189 million) over 5 years, and 3) the cost of funding the Corporation's administrative activities at the current level (with a provision for inflation).

COMPONENTS OF THE REQUESTED PREMIUM

	Cost per participant	Percent of premium
Financing of expected future net claims	$3.02	50.9
Administrative expenses	.97	16.3
Retirement of the expected December 31, 1982 deficit over 5 years	1.95	32.8
Accrual of reserve for contingencies	0.00	0.0
Total	[1] 5.94	100.0

[1] Rounded to $6.

Source: PBGC, Premium Requirements for the Single Employer Basic Benefits Program, May 1982, page 27.

Question 7. Will this increase build up the Corporation's financial reserves or will it merely cover administrative costs, claims, and amortization of existing deficits?

PBGC response. In developing this premium request, no specific provision was made for a reserve or surplus to protect the Corporation against large claims or any other unexpected contingencies. In the Corporation's judgment, accumulation of a surplus is unnecessary because of the compulsory nature of the insurance program. The premium is made up of three components 1) a provision for future claims, 2) a provision for the funding of administrative expenses, and 3) a provision for retirement of existing deficits.

Question 8. What is the view of the Corporation regarding a dual rate premium structure which would include both a per capita premium and a premium based on a percentage of a company's unfunded liability? What are the administrative difficulties for the Corporation and plan sponsors in implementing some form of liability based premium?

PBGC response. The Congress has made a judgment that all defined benefit plans should share in the risk of guaranteeing pension benefits. Congress did give the PBGC the authority to propose, at some future time, a risk-related premium which must be submitted for Congressional approval. We are currently making an extended study of the feasibility of establishing a risk-related premium. We hope to complete that study by the end of this year. Many factors are involved in its assessment. For example, the PBGC might have to promulgate specific assumptions to be used by actuaries in determining the degree of underfunding. (Normally, actuarial assumptions vary widely from plan to plan, and therefore, the amount of underfunding for two similarly situated plans could be different depending on the assumptions.) There would be much cost and expense to the plans. Moreover, the degree of underfunding is only one measure of the PBGC's risk on exposure in the insurance system. One must take into account an employer's ability to continue its pension plan, the chances that PBGC will recover enough employer liability under Title IV to cover the cost of the plan should the company decide to terminate it and many other factors including the best methods of achieving underlying congressional purposes in establishing an insurance system protective of defined benefit plans and their participants. For these reasons, the construction of a "risk-related" premium is an involved task.

Question 9. Has the Corporation conducted any studies to determine whether increased premiums will act as an incentive for employers to terminate plans or if such increases will discourage the formation of new defined benefit pension plans?

PBGC response. The Corporation has not conducted any statistical studies to determine the effect of the proposed increased premium on plan terminations or on formation of new plans. However, based on data gathered annually by the U.S. Chamber of Commerce,[1] the $6.00 premium will still represent: less than 1 percent of the annual cost to a typical employer of maintaining a pension plan; about 1/10 of 1 percent of a typical employer's annual payment for all employee benefits; about 4/100 of 1 percent of typical annual payroll costs; and about 3 mills per hour worked. We have also talked with a wide segment of representatives of small and large businesses and have found that the need for the increased premium is widely accepted when the facts of the system are clearly presented.

Question 10. What steps should Congress take to improve the operation of the Corporation? Does it support pending legislation or would it recommend specific legislation to this end?

PBGC response. To improve the operation of the Corporation, the Administration is in favor of the following:

Approval by the Congress of the proposed premium increase to $6.00, effective January 1, 1983.

Approval of amendments to existing law which would substantially reduce the number of terminations presented to the PBGC for handling and also reduce unnecessary losses to the insurance program caused by a strong employer's program transferring its plan to a weak buyer. In these cases, without the above legislation, PBGC is not able to recover its losses from the prior employer allowing some employees to use this "loophole" in ERISA to their advantage.

Question 11. What should be the creditor status of the Corporation in the event of an employer bankruptcy? If the Corporation comes before other creditors, will banks or other financial institutions raise the cost of borrowing for employers who are facing large unfunded liabilities or face imminent financial difficulty?

PBGC response. Under ERISA, PBGC's claim for an underfunded terminated single employer plan against an employer in bankruptcy has the priority status of a tax due and owing to the United States. The amount of PBGC's claim is the value of unfunded guaranteed benefits, but limited to 30 percent of the employer's net worth. Because the net worth of companies in bankruptcy is low, PBGC's claim in bankruptcy is generally significantly reduced because of the 30 percent of net worth cap. The priority status of PBGC's claim has therefore been an important factor in PBGC's ability to recover from companies in bankruptcy proceedings.

Proposed amendments to Title IV of existing law which are now under consideration by the Senate Subcommittee on Labor would retain the PBGC 30 percent net worth but would also permit PBGC to elect general creditor status with respect to its claims against a corporation for guaranteed unfunded vested liabilities. If the plan of a particular company did not satisfy certain funding levels in the year in which an insurable event occurs (e.g., liquidation of the company), the PBGC claims would have general creditor status. If such funding levels are met, the PBGC claim would be subordinated to claims of general creditors. There are many other details but the expected net result is that the insurance system would be strengthened by such legislation. It would be generally in accord with the Administration's prior testimony in favor of general creditor status for the PBGC and against a proposal by others that the PBGC claims should be subordinated to all other general creditors, secured or unsecured.

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[1] Employee Benefits 1980, Chamber of Commerce of the United States.

It is difficult to estimate whether general creditor status for PBGC's claim will significantly increase the cost of credit to weak or marginal companies. Banks and institutional lenders rarely make loans to companies in serious trouble except on a secured basis. This was true even prior to ERISA when there was no liability to PBGC. Recovery on secured loans in a bankruptcy proceeding will not be jeopardized by making PBGC a general unsecured creditor since secured creditors are satisfied before unsecured creditors.

Representatives of some large unfunded vested liabilities maintain that general creditor status for PBGC claims will increase the borrowing cost by one tenth of 1 percent. Representatives of Small Business also asserted that general creditor status make it more difficult for them to borrow money. We have not been able to verify the accuracy of such claims but the legislation now under consideration is considered to be a fair approach to this program and to the maintenance of a sound insurance program that is designed to protect 30 million participants.

Question 12. Does the Corporation need more authority to regulate employers who participate in the plan termination insurance program to better prevent plan terminations?

PBGC response. Most of the losses to the single employer insurance program have occurred in connection with employers going out of business, generally because of reorganization under the bankruptcy laws or a liquidating bankruptcy. Most of these plan terminations are unavoidable. There is one class of terminations which should not be allowed to create losses for the insurance program; namely, terminations by employers that continue in business after the plan is terminated and the losses thereby shifted to PBGC's premium payers. To date, PBGC has contested two such terminations (Alloy Tek and Facet Enterprises). If ongoing employers are permitted to free themselves of their funding obligations in this way—i.e., by invoking the 30 percent of net worth cap—such terminations could in time have a very destabilizing effect on the insurance program as this method of shedding pension obligations becomes more commonplace.

Proposed legislation would prevent this from occurring by requiring an ongoing employer to complete funding all vested benefits in a single employer plan. PBGC would become involved only in the event of liquidation or bankruptcy. In the case of liquidations whether or not in a bankruptcy proceeding, PBGC would have a claim for unfunded guaranteed benefits. In non-liquidating bankruptcies, PBGC would have the option of triggering a claim. There would be no truly voluntary terminations resulting in losses to PBGC as current law permits. Ongoing employers that need to control plan costs could amend their plans to cease crediting of further service for any purpose; the employer would then complete funding of vested benefits under the plan, including benefits in excess of PBGC's guarantees. The legislation therefore would provide better protection of vested benefits than current law.

Another category of termination that produces unnecessary losses to the insurance program is termination of a plan that has been transferred to a weak employer, e.g., in connection with the sale or spinoff of a business whose employees are covered by the plan. In such cases, PBGC has not been able to recover its losses from the prior employer, even though most of the losses were attributable to the prior employer. S. 1541 and H.R. 1330 and 4334 would remedy this situation by creating secondary liability for prior employers, with certain exclusions for transfers that pose little risk to the insurance program.

To a large degree, PBGC losses are due merely to inadequate funding of pension benefits prior to the insurable event. Stricter liability rules under Title IV could spur a better balance between benefit promises and contributions in plans and thus enhance security for the future.

Question 13. What needs to be done to better coordinate the efforts of the Corporation, the Department of Labor and the Internal Revenue Service to prevent the termination of pension plans?

PBGC response. Unnecessary or abusive terminations can only be prevented by statutory change as discussed in Item 12 above. However, the losses incurred in terminations that occur can be reduced through interagency cooperation under current law. The authority to grant funding waivers is now given to the Internal Revenue Service. The amount of plan contributions thus waived may wind up as an additional claim against PBGC. If the PBGC were to be given by law a role in the processing of granting of waivers, potential losses to the PBGC could be reduced. The investment restrictions under the general jurisdiction of the Department of Labor, and not the PBGC, obviously impact the type of investments purchased by plans. Close liaison by the Department of Labor and the PBGC could prove to be beneficial. Considerable progress has already been made in this area and the chief administrators of each of the affected governmental departments or agencies are meeting on these matters in an effort to better implement the responsibilities given respectively to each department and agency.

Question 14. Will the Corporation propose any change in its present basic benefit coverage?

PBGC response. The Corporation does not propose any change in its basic benefit coverage. The American Society of Pension Actuaries and certain business groups testifying on PBGC's recent request to the Congress to increase the premium rate for the single employer program questioned whether PBGC should guarantee certain benefits. Doubtless cutting PBGC's coverage would save the program money. However, reducing coverage is not the best way to adjust the higher than projected level of claims that PBGC has experienced.

Changing the law to require ongoing employers to complete funding their plans and to induce better funding through an altered PBGC claim in the event an insurable event does occur, are better methods to reduce claims than reducing the guarantees. Moreover, the increased premium which PBGC has requested—$6.00 per covered participant per year—is a small price to pay for the retirement income security promised to American workers when ERISA was enacted. There is no compelling economic justification for reducing coverage that can be so inexpensively provided (one-third of a cent per hour based on 2,000 hours; four-tenths of a cent per hour based on 1,500 hours).

The CHAIRMAN. Now, we have another excellent panel here, panel III.

PANEL THREE, CONSISTING OF RAYMOND HARWOOD, RETIRED CHAIRMAN OF THE BOARD, HARPER & ROW PUBLISHERS, ASHEVILLE, N.C.; REGINA C. LITTLE, EXECUTIVE ASSISTANT TO DAVID LIVINGSTON, PRESIDENT, LOCAL 65, UAW (HARPER AND ROW), NEW YORK, ACCOMPANIED BY JANET GOLDSTEIN, RENEE CAFIERO, AND EUGENE MITTELMAN; WILLIAM WALSH, RETIRED EXECUTIVE VICE PRESIDENT AND MEMBER OF THE BOARD OF DIRECTORS, GREAT ATLANTIC & PACIFIC TEA CO., RIVERDALE, N.J; AND ED MILLER, GENERAL COUNSEL, VICE PRESIDENT, HARPER & ROW PUBLISHERS

STATEMENT OF RAYMOND HARWOOD

Mr. HARWOOD. Thank you, Mr. Chairman.

I have a written statement which I had previously submitted, but I have varied it a bit, so I would rather read it with my changes.

The CHAIRMAN. Very good.

Mr. HARWOOD. I appreciate the opportunity to appear before you as I feel that this committee is confronting a growing evil which at this crucial time threatens all private pensions. I say crucial time and I am referring to the doubts being expressed about the future of Federal social security and I think it makes people concerned, as they should be.

Anything which undermines the integrity of private pensions quite properly causes concern among the aging of this country and, merits the attention of this committee.

If there is any doubt about how important private pensions are to the economic and social framework of this country, I recommend a reading of Peter Drucker's "The Unseen Revolution," subtitled "How Pension-Fund Socialism Came to America."

This author is a distinguished management consultant. Strangely enough, the publisher is Harper & Row. It is a pity that the current management of the company didn't read the book.

My name is Raymond C. Harwood, and I now reside in Asheville, N.C. I retired as chairman of the board of directors of Harper & Row in 1969. I am a certified public accountant who joined the predecessor to Harper & Row—Harper Bros.—in 1930 as an assistant treasurer.

I was president of Harper in 1962 when it became Harper & Row, Inc., and went public. I served on the board of directors during the time the pension and profit-sharing plans were designed.

My direct personal interest in this side of the Harper & Row problem is minor. I should like to have it noted that my pension from the company is fully vested, I have been told, and underwritten for life by an annuity policy issued by the Prudential Life Insurance Co.

Similarly, my profit-sharing account has been balanced by payments made to me over the past 12 years. Any financial damages which I might have suffered as an outside stockholder will have to be considered in private litigation against the management and the directors and the inside director who benefited by the transaction, which I will describe later. A shareholder suit has been initiated. This litigation by stockholders other than myself, has already begun in Delaware.

To me it is a matter of principle and fairness to employees who worked faithfully for me, now nearing retirement. My career with Harper & Row provided me with a splendid opportunity to recognize the need and evaluate the importance of private pension plans to both employees and their employers as well as the national economy.

It pleased me that the Internal Revenue Service so readily accepted annual contributions to pension and profit-sharing plans as proper business deductions in computing corporation income taxes.

And I was encouraged by the enactment of the Employee Retirement Security Act, ERISA, in 1974.

I have always believed that the trust characteristic of funds accumulated for the exclusive benefits of employees and the strong prohibition against the diversion of such funds for company purposes were highly desirable.

For some time, the combination of these reasonable restraints appeared to be adequate to protect the interests of employees who merely wanted to spend an active life at good wages and to be able to rely on a decent private pension, along with Federal old age pension, to support them after retirement.

However, recently, there appears to be a growing shadow cast over this American dream. This is evidenced by the number of violations of these trust funds. I am not sure that the U.S. Department of Labor under ERISA, or the SEC have either the means or the inclination to handle this serious problem.

It seems clear that the principal cause of this unfortunate change is the good investment income experience of many longstanding plans in relation to the actuarial computation used in determining the level of past annual employers' contributions.

Some enlightened management have seen this as a good opportunity to increase benefits to offset the impact of inflation. Others to reduce company contributions in future years. Still others, however, have not been able to resist the temptation to recapture these excess funds and put them to use for company purposes.

It is the latter to which this committee should direct its attention. Unfortunately, Harper & Row seems to have fallen into this third group deciding, unilaterally, that funds accumulated could be used for purposes other than those for which they were originally intended and for the private gain of favored individuals.

Let me provide this committee with the specific background which led to the termination of the Harper & Row pension plan and the suspension of the profit-sharing plan, two individual plans—both in existence for many years.

After Harper & Row went public in 1962, the Minneapolis Star-Tribune was encouraged to acquire large blocks of the company's stock and by 1981, they owned approximately 1 million shares, or one-third of the outstanding shares of the company.

The Minneapolis Star-Tribune Co. is a private company owned principally by the Cowles family, and during the ensuing 19 years, Mr. John Cowles, Jr. served on the board of directors as chairman of the board, as chairman of the executive committee, as chief executive officer.

Incidentally, he is related by marriage to a principal Harper stockholder. He and his company were clearly insiders. He put in place the present management and the current Harper chairman of the board is still a member of the Minneapolis Star-Tribune board.

In 1981, the Minneapolis Star-Tribune announced its intention to liquidate its holdings in Harper & Row to use these funds for their principal operation in Minneapolis. They offered the corporation, Harper & Row, first option to purchase the stock.

The Harper & Row management came to the conclusion that this amount of stock in unfriendly hands would be unsatisfactory to both the corporation staff and its authors. However, there were at this time no active takeover bids threatening the corporation's independence and no attempt was made to determine how the employees felt.

Furthermore, the company was profitable. There was no justification in terms of financial stress.

Long negotiations between Minneapolis Star-Tribune and the Harper management, concluded with a cash price of $20 per share for the stock, twice what the stock was selling for in the over-the-counter market at that time.

An "independent expert," and here I must use quotes—Kidder Peabody, issued an opinion letter stating this was a reasonable price. It should be brought to the attention of the committee that Kidder Peabody has had a relationship with Harper & Row since 1962 and in this instance they received a very substantial fee for their opinion and were completely indemnified by Harper & Row.

Having determined the price to be paid per share of stock, the management of the company had to put together a fund of over $20 million to consummate the deal, and all of this sum was not readily available within the company, and the following plan was advised.

First. Terminate the pension plan and withdraw funds in trust in excess of the vested pensions. This was estimated to produce $9.6 million.

Second. Discontinue the profit-sharing plan and sell a portion of the acquired stock to the profit-sharing trust to cover vested benefits, estimated to produce $1.5 million.

Third. Sell company-owned real estate estimated to produce, net, $4.5 million.

Fourth. Use company's excess cash—question mark—or credit, estimate to produce $4.6 million.

It is apparent, therefore, that the pension and profit-sharing trusts were called upon to provide over half of the $20.4 million required to secure the stock. This amount roughly represents the premium paid over market price for the shares.

One is prompted to wonder how much the trustees of these two plans had to do with these financial decisions or whether their responsibilities ended before they had an opportunity to vote on the disposition of the funds of the trusts.

The management decision required approval of the board of directors and the stockholders.

The board voted approval unanimously, but without the vote of Fred Taylor, formerly an officer of Kidder Peabody, and director of Harper & Row since 1962, who abruptly resigned before the vote was taken.

Under pressure of a timetable which prevented any reasonable indepth study of this complicated deal, the stockholders approved the sale. And here I can describe that telescoped timetable. The fiscal year ended April 30, 1981 and it was expected, certainly on the basis of past experience, that an annual meeting would be held at least no longer than 3 months after that, and that would have made it July 31.

However, the proxy statement was dated November 10 and the annual meeting was set at December 9 and the transaction had to be concluded by December 31 to save the company a $1 million penalty held in escrow relating to the completion of the deal.

Even so, there were about 500,000 unorganized shares voting in opposition to the transaction and this, in my judgment, reflected the fact the reasons given for the transaction were unimpressive.

The arrangement proposed by the management and endorsed by the board of directors and accepted by the shareholders contained a number of curious provisions favoring the inside stockholder at the expense of Harper & Row and/or its employees.

In addition to the price of $20 per share paid by Harper & Row, Harper & Row agreed to share any profits on the subsequent sale of the acquired stock over the next 2 years. This seemed to assume that the company, rather than the new employee stock ownership plan, would control the stock over at least the next 2 years.

The selling stockholder was completely indemnified against any claims based on the contract by third parties. The selling stockholder had the advantage of the $1 million escrow agreement to which I referred, virtually assuring the acceptance of the management's proposal by December 31, 1981 to avoid financial penalty.

The new employee stock ownership plan is not an adequate substitute for the terminated stock pension and profit-sharing plans. On the contrary, it is a retrogression. It is only assured for 5 years and the full employee ownership of the stock delayed. During the interval in ownership the company will vote the acquired shares.

It is naive to assume that in the absence of the security of a basic private pension plan with a fixed formula for determining retirement benefits, and a commitment from the company to actuarily-determined annual contributions funded by a trust with a diversified investment portfolio, that the staff would have a high level of morale and increased productivity, as anticipated.

ESOP, the employees stock ownership plan, was never intended to replace a formal pension plan or to be used as a device to bail out a favored inside stockholder. The continued downward drift of the market price of Harper & Row stock since December 31, 1981, the date of the consummation of the deal, appears to be early confirmation of the doubts expressed about the viability of the entire deal at the annual meeting of the corporation last December.

The most recent quote in the over-the-counter market is about 8½. The price quotation at the end of the year was about 10½, and this was the stock that the company paid $20 a share to obtain.

It is not surprising that prior to stockholder approval of the deal, a rather intensive but subtle lobbying campaign, was conducted by top and middle management. It was particularly distressing to me to see this occasionally focused on employee stockholders in the company, employees who had to protect their jobs.

In summary, this is an outrageous move to favor a single inside shareholder and entrench present management at the expense of employees and other stockholders. The employees, without any voice in the matter, have lost the security of trusteed pension and profit-sharing plan, and have had to accept, in exchange, the imponderables of a stock ownershp plan in a single company—the company they work for.

This has been a blow to employee morale. Further, the company has had its financial structure seriously weakened by the diversion of working funds, the extension of credit and the sale of real estate, all of which tend to undermine the value of the stock which is being turned over to the employees stock purchase plan and the stock owned by outside shareholders.

Moreover, operations of the company are negatively influenced by:

One, the impact of the substantial expenditures relating to the plan termination, and the purchase of stock by the corporation—according to the most recent quarterly company report, associated fees total over $600,000.

Two, the corporation is likely to experience difficulty in retaining and recruiting qualified employees without a formal pension plan.

In contrast, a single stockholder has been unreasonably enriched as a result of a use of past accumulated pension and profit-sharing funds and corporate resources in a stock purchasing arrangement with favorable terms not available to other stockholders who own the remaining two-thirds of the stock.

Now, here, I do not contend that the company did not have a legal right to terminate the plans. That was carefully spelled out in these plans. This is a morale problem, however, aggravated by the excess payment for the stock purchased.

If all this can happen under existing law and regulations of the Department of Labor, the Securities and Exchange Commission, and the Internal Revenue Service, it would appear that new legislation is required to reinforce the rights of senior citizens approaching retirements, and small investors.

It is apparent to me from the number of unsolicited communications which I have received from individual Harper & Row shareholders and employees that despite the approval of the arrangement by the stockholders at the annual meeting, considerable concern still remains among employees and the unorganized shareholders.

I should be glad to answer any questions. You can be sure that making this statement has not been a pleasant experience for me. Thank you.

The CHAIRMAN. Mr. Harwood, I want to commend you that you have been willing in the public interest to come and make the statement that you have made today.

Mr. HARWOOD. Thank you.

STATEMENT OF REGINA C. LITTLE

Ms. LITTLE. Thank you, Mr. Chairman.

I am the executive assistant to David Livingston, president of district 65, who sends his apologies for not being able to be with us today.

District 65, UAW is a labor union which represents thousands of workers in diverse industries. Accompanying me are Janet Goldstein, Renee Cafiero and Eugene Mittelman. Ms. Goldstein is an employee of Harper & Row and co-president of the Association of Harper & Row Employees within district 65, UAW. Ms. Cafiero is a colleague of hers at Harper & Row and membership secretary of the local. Mr. Mittelman is of the firm Mittelman & Gordon. We have retained Mr. Mittelman's firm to bring suit against Harper & Row because of the injury to our members wrought by the changes in its retirement and profit-sharing plan. My testimony is given on behalf of the president of district 65, UAW.

We offer our testimony because protection of the rights of each individual to an economically secure and dignified retirement is one of particular concern to our union. Although we are bringing to the attention of this committee an example of a callous move by Harper & Row Publishers, Inc., to sacrifice its employees' security, we do so because we believe it reveals a potential threat to others as well. We are concerned that other employers in publishing and other industries will attempt to use the technique developed by this corporation to use workers' security as a pawn in corporate power games. The experience of the Harper & Row employees is illustrative of a deficiency in the present system for the protection of retirement security.

Specifically, it has become necessary for us to undertake costly litigation to enforce the rights of the employees of Harper & Row.

We have filed suit against Harper & Row and related individuals and companies, as well as the Prudential Insurance Co. of America and the PBGC. A copy of our complaint is being submitted to the committee along with this statement, and we ask that it be made a part of the record.

[See appendix II, p. 162 for material submitted by Ms. Little.]

Ms LITTLE. We believe that a system in which workers must sue to protect themselves is one which does not inspire the respect or confidence of the people. Moreover, it is one which only encourages further corporate abuse.

Let me briefly review the facts on which our complaint is based.

In February 1981, the Minneapolis Star & Tribune Co. told Harper & Row it planned to dispose of its block of 1 million shares of Harper & Row stock, which amounted to approximately one-third of all of Harper & Row's outstanding stock. There is no dispute that whoever owned or controlled that stock controlled Harper & Row.

The present Harper & Row management decided to prevent the stock from being sold to a third party, so they entered into an agreement with the Minneapolis Star & Tribune under which Harper & Row itself would buy the stock for $20 per share.

Harper & Row stock was then being traded in the range of $10 to $13 per share. To finance a major portion of this rather unusual transaction, Harper & Row decided to use approximately $11.5 million of money in its retirement and profit-sharing plans.

In the case of the profit-sharing plan, which had total assets of $3.5 million in 1981, and to which the company was committed to contribute 10 percent of its profits, the approach was as follows:

The investment policy of the plan had been to invest in two funds, a fixed income and an equity fund, both of which were diversified. Participants were given a choice of how they wanted their money invested. All this was eliminated; mandatory contributions of 10 percent of profits were discontinued, and the plan was required to buy and hold about $1.5 million of the stock to be acquired from the Minneapolis Star & Tribune Co.

In the case of the retirement plan, the action was even more drastic. The whole plan was terminated and about $10 million in allegedly "excess" assets were "returned" to the company, to be used to purchase the controlling stock.

A large portion of the controlling stock not purchased by the profit-sharing plan was contributed to an employee stock plan, which was purported to provide the employees with the same benefits they would have accrued under the pension and profit-sharing plan had they remained in effect.

We believe that in engaging in this whole series of transactions, Harper & Row and its directors and plan fiduciaries violated their fiduciary responsibilities under ERISA, and also violated the applicable Federal and State securities laws. Yet, so far, none of the Federal agencies directly concerned, including the PBGC, the Labor Department, the IRS, and the SEC, has taken a single step to stop the present management of Harper & Row from jeopardizing the retirement security of our members in order to preserve its control of the company.

ERISA requires that plan fiduciaries act prudently and for the exclusive benefit of participants and beneficiaries. It also requires that participants and beneficiaries be paid the full value of their benefits under a plan. Our complaint alleges that Harper & Row, its directors, its plan fiduciaries, Prudential and PBGC all violated ERISA for the reasons summarized herein.

The purpose of all of these actions was to enable the present management of Harper & Row to retain its control of the company. As a union, we have no objection to present management retaining its control, but not at the expense of our members' retirement security. The employee stock plan may look good on paper, but it is not the equivalent of the guaranteed, insured benefits our members had under the pension plan. Moreover, our members have already sustained a big loss under the employee stock plan. The stock which was contributed to that plan was valued at $13 per share. Its actual present market price is $8 to $8.50 per share. On 800,000 shares of stock that is already a loss of $3 to $4 million.

The allegedly "excess" assets of close to $10 million in the pension plan were literally created to suit the occasion through the device of paying all benefits—even lump sums for annuities valued at less than $1,000—through an insurance policy bought from Prudential, the cost of which was based on a 15-percent interest assumption. Any actuary or insurance person will verify that an individual who is not within a year or two of age 65 who tries to invest less than $1,000 cannot possibly obtain a guaranteed 15-percent return until age 65. The best evidence of this is the experience of Ms. Renee Cafiero, who is named as a plaintiff in our suit. Ms. Cafiero was entitled to an annuity of $122 per month at age 65. She is 38.

She called Prudential and asked what the premium would be for her to buy such a deferred annuity for herself. Incredible as it sounds, Prudential quoted her a premium of $7,596. However, Prudential offered to pay Ms. Cafiero only $343 as the lump sum value of her annuity under the Harper & Row plan. The difference is attributable to the interest rate assumption.

There are probably over 1,000 Harper & Row employees who were similarly deprived of the fairly determined value of their accrued benefits under Harper & Row's pension plan, none of whom were ever told that they were being paid their money on the assumption that they would be able to get a 15-percent return on it indefinitely.

Who benefited by the difference? Harper & Row, which used the low lump sum values to create the illusion that there was a $10 million surplus in the plan. If all the lump sums had been properly computed there would have been substantially less of a surplus, perhaps none at all. Who decided to use a 15-percent interest rate factor? The fiduciaries of the plan, who were supposed to be acting for the "exclusive benefit" of the participants and beneficiaries in setting interest rates and other actuarial assumptions.

Under the law, the PBGC is supposed to investigate any terminating plan to insure that participants actually receive what they are entitled to under the law. We do not think the PBGC made any real investigation in this case. It seems to have just accepted the premium quoted by Prudential as the amount necessary to pay all accrued benefits without making any inquiry to see if the amounts to be paid by Prudential were correct, especially in the case of lump-sum benefits.

We hope that this committee will take a close look at the PBGC's procedures in this case. We call the committee's attention to the fact that the highest interest rate ever used by the PBGC, itself, for valuing immediate annuities was 10.75 percent.

Given the fact that interest rates presently are at an all-time high, for deferred annuities the interest rate should be lower than 10.75 percent. Under the circumstances, we think the PBGC failed to properly discharge its responsibilities, and that is why we have named the PBGC as defendant in our suit.

The purchase of $1.5 million worth of the controlling stock by the profit-sharing plan was not done for the exclusive benefit of employees and was not prudent under the circumstances. The purchase took place under almost the identical circumstances as the purchase by the Grumman pension plan of Grumman stock during the Grumman/LTV takeover flight. The Department of Labor sued Grumman over that purchase and has prevailed, on the merits, in both the district court and, recently, in the U.S. Court of Appeals for the Second Circuit.

The Department of Labor has been investigating the Harper & Row case since the fall of 1981. So far it has not sued, as it did in Grumman, nor has it exonerated Harper & Row. I hope that this committee will also take a close look at the Labor Department's procedures in this case. There is no conceivable excuse for the Department's inaction. Certainly the Department has had ample time to complete any reasonable investigation. If the Department has concluded that Harper & Row did not violate the law, it ought to say so publicly; if it has concluded that Harper & Row did violate the law, then it should have moved in court long ago to stop Harper & Row from proceeding with its plans.

We have undertaken what will undoubtedly be a protracted, expensive lawsuit only because the Government agencies primarily responsible for protecting our members' interests have fallen down on the job. We are firmly convinced that the incumbent management of Harper & Row had no right to use our members' retirement security—their money—for its own purposes in a high stakes corporate poker game for control of the company.

We would like to point out that ERISA seems to have a double standard embodied in it. District 65, UAW has a $170 million multiemployer pension plan covering 25,000 participants and beneficiaries. There are strict limitations—properly so, in our opinion—on any direct dealings between any contributing employer and the plan, and on the amount such a plan can invest in one of our contributing employer's own stock. Any deviation requires the consent of the Labor Department. As a matter of policy, we refrain from all such investments. But our attorneys tell us that while ERISA is very strict as to our plan, and would be enforced rigidly by the Labor Department against us, single employers such as Harper & Row can set up profit-sharing or stock plans which are administered without union participation and which can trade in the securities of the employer without ever getting an exemption from the Labor Department. Such investments are subject to legal scrutiny only under the more general "prudent man" and "exclusive benefit" rules.

What Harper & Row did in this case shows a potential loophole in the present law. If Harper & Row can do what it has done without challenge from the Labor Department, the PBGC, the IRS, or the SEC, then any other employer can do the same, and will likely escape any challenge at all if there is no union willing to undertake the costs of financing litigation.

ERISA should be amended to prohibit, absolutely, any use by employers of the assets of any pension plan—whatever the form of the plan—for the purpose of buying stock or otherwise investing in the employer unless the Labor Department grants an exemption based on a finding that such investment is in the best interest of the participants and in no way jeopardizes other aspects of the retirement security of employees. I urge this committee to recommend prompt approval by the Congress of such an amendment. The experience of the employees of Grumman and Harper & Row demonstrates that such an amendment of ERISA is necessary to insulate, totally and finally, employee pension plans from being manipulated by the incumbent management of publicly-held companies to insure that they will retain control of their companies at the cost of the employees' security.

In addition, ERISA and the securities laws should be amended to require that all stock held by an employee benefit plan must be voted in the same proportion as stock not so held. This will serve to insulate such stock from contests for corporate control and, we are informed, is similar to a requirement of the New York Stock Exchange which is imposed in cases where the issuance of new stock would dilute the voting interests of existing shareholders.

Mr. Chairman, we wish to close by commending you and your colleagues for holding these timely hearings. The fiduciary principles established under ERISA go a long way in safeguarding employees against corporate raiding of employee pension funds, but they may not go far enough to assure that employees are fully protected against the designs of fiduciaries who put other interests ahead of the interests of the participants and beneficiaries they are supposed to serve.

Nothing could go further to undermine the confidence of employees or the integrity of the private pension system than the suspicion—which could readily ripen into a belief—that despite ERISA, management has created loopholes that permit them to divert employee pension fund moneys from their intended purpose.

Congress should not sit idly by and watch such a potentially devastating development take place. No matter what the courts may ultimately decide in the case we have filed, this committee can perform a valuable service if it registers its opposition to what Harper & Row did and recommends appropriate legislative steps to assure that it will not occur again.

I invite the committee to ask questions of myself or of the other people accompanying me.

The CHAIRMAN. Thank you very much. We appreciate the excellent statement you have given, Ms. Little.

Do you or your people wish to say anything?

Ms. LITTLE. Not at this time, Mr. Chairman.

The CHAIRMAN. Our next witness will be Mr. William Walsh.

STATEMENT OF WILLIAM WALSH

Mr. WALSH. Mr. Chairman, first, I would like to advise the committee that the bulk of the audience sitting here today are fellow A&P retirees, most from the Philadelphia area and the Baltimore-Washington area. They boarded a bus from Philadelphia at 6 a.m. this morning, because they respect and appreciate the opportunity to partake in this process.

The CHAIRMAN. We are very grateful that they came.

Mr. WALSH. Mr. Chairman and members of the committee, my name is Bill Walsh. I reside in Rivervale, N.J. I am the plaintiff in the class action filed in Federal court to prevent A&P from diverting a surplus of over $250 million from the employee pension plan for corporate uses.

My employment with A&P began in 1939 as a part-time clerk and continued after return from service on a full-time basis for 36 years in a wide variety of responsibilities. In 1971, I was elected executive vice president of the company and a member of the board of directors. I am now retired.

A&P has announced tentative settlement of this case, but I have very serious objections to this proposal which I consider inadequate, inequitable and unreasonable. Anticipating favorable court action, A&P has already credited $130 million of the surplus to 1981 earnings.

I am not here as a laywer and it is not my purpose to try this case before this committee, but rather, based upon experiences gained, we hope to bring to your attention considerations which can be of value to this committee in developing legislation to better protect pension benefits which employees have earned.

A&P has a corporately funded, defined benefit pension plan in which some 30,000 members are vested. Over 75 percent of the participants are either retired or have been terminated from employment with A&P.

I had direct involvement in the administration of this plan in its early years and have been closely acquainted with improvements to the plan over the years to 1975. A&P management since 1948 has consistently made straightforward promises to the members that all funds in the plan, after administrative expenses, must be used for the exclusive benefit of members. During my tenure as part of senior management, I repeated this promise on numerous occasions when the question of the security of the plan was raised by members.

The A&P Tea Co. was already 99 years old when this plan was founded in 1948. At that time, many employees had accumulated long service and were at, or approaching, retirement age. Therefore, despite very generous contributions by management, the plan was not fully funded until 1960. In those years, the company expressed to employees the hope to continue the plan indefinitely and cautioned that in the event of termination, retirement allowances may have to be reduced proportionately if total funds were insufficient.

Starting in 1960, and continuing for 16 years through 1975, the explanatory booklets describing the plan and distributed to employee members contained the identical plan-continuance paragraph which read as follows:

> The Company hopes and expects to continue the plan indefinitely, but reserves the right to amend or discontinue it at any time. Of course, anything you can do to help keep our business successful will help assure the plan's continuance, however, if the plan should end, all plan funds must be used for the benefit of members and their beneficiaries.

To further codify and strengthen member rights, the board of directors, of which I was a member, amended the text of the plan in 1973 to read as follows:

> Excess assets: If upon termination of the plan, there is an amount remaining in the trust fund after satisfying all liabilities, then, and not otherwise, the trustee shall apply the amount to so remaining in the trust fund pro-rata to the benefit of each class set forth in subsection 11.1, as recommended by the actuary for the plan and approved by the retirement board.

The classes referred to in subsection 11.1 are members either retired, actively employed or terminated with vested benefits.

This 1973 amendment, awarding excess assets to members, has been approved by IRS and has continued in the official text of the plan until June 26, 1981. This wording in the text is very important, because unfortunately, promises as explicit as this in summary booklets have been held meaningless and dismissed as meaningless in recent court rulings, primarily because those comments in the summary booklet differed from what the text said.

In January 1979, Mr. Erivan Haub, a West German national, announced his intention to secure a major interest in A&P. Mr. Haub, through Tenglemann, Inc., now personally owns more than 50 percent of A&P stock and effectively controls the company. During the years 1979, 1980, and 1981, this new management did not contribute any funding to the pension plan, yet the surplus in the plan continued to grow well in excess of $200 million.

In 1981, the decision was made to terminate the plan since termination offered the only possibility for diverting the surplus to corporate uses.

The members of the A&P board of directors are each selected and elected by Mr. Haub. On June 26, 1981, this board dutifully amended the termination section of the plan to now read that excess funds remaining in the plan upon termination would revert to the company. Members have never been advised of this amendment to this day.

On October 16, 1981, this board announced the intention to terminate the plan and divert the surplus to corporate uses.

Sadly, this same group of board members is charged with the fiduciary responsibility to govern the pension plan in the best interest of the members. They decided not to share any of the surplus with the more than 26,000 retired or terminated with vesting members or with the actively employed members. The plan had never been indexed and many members retired after well over 25 years service receive less than $1,500 per year in benefits. All requests for increased benefits to offset inflation have gone unheeded.

In my judgment, it defiles the very essence of the word trust that funds contributed over 30 years into a pension trust as a component part of the wage package, and I think it makes not one hair of difference whether the company contributes all or the employee makes a contribution, it is all considered as part of the wage package—that such a fund can be wrenched from this trust to satisfy the greed of a company wishing to stuff its treasury be reneging on promises made to employees over those many years.

The assets of the pension trust have never appeared on the balance sheet of A&P and they are not the property of any shareholder. Surely, the company has far less claim to the proceeds of this trust than do the employees for whom the trust was founded and funded.

This case suggests a number of considerations for members of this select committee:

First. Pension trusts must be governed in the best interest of the members. A board of directors, chosen by the majority stockholder who is intent upon diverting the plan surplus, finds itself in a difficult conflict of interest position if it also attempts to exercise fiduciary responsibility in the best interest of plan members. This results in the classic case of the fox guarding the chicken coop.

Second. Pension trusts are established as part of the wage package to benefit employees and must not be retrievable by the company under any circumstance. Any deviation from this rule invites corporate connivance and is realistically unnecessary.

Third. The law should mandate distribution to members of a reasonable percentage of surpluses which occur in pension trusts. Prudent pension management can use indexing or a one-time distribution of added benefits to draw off surpluses which result from the recent high interest rates, a dramatic reduction in numbers of employees or other known factors.

In this instance, A&P has stated that should the court not award this surplus to the company, they will reverse their decision and not terminate the plan. Thus a heavily overfunded plan will sit while the overwhelming majority of members for whom the plan was founded continue to endure the ravages of the same inflation that helped to create the surplus. This is a highhanded "heads I win, tails you lose," attitude that cannot be tolerated after the company has not only announced termination, but has already credited a portion of the surplus to earnings.

Fourth. Members are entitled to prompt notification of important changes in plan texts and to a "summary of the annual report for employees' retirement plan" that is understandable and complete.

As stated earlier, the amendment awarding excess assets to members upon plan termination was taken out of the plan on June 26, 1981, and the members have not been notified to this day.

The annual reports of the pension plan for the past few years are unintelligible inasmuch as the amount of any surplus is neither referred to or determinable. Instead, it is mentioned that an actuaries statement shows no funding deficiency.

Fifth. Plan texts must be clear and forthright. Ambiguities between the employee booklets and the plan texts, or ambiguities or contradictions within the plan text itself must be eliminated or decided upon against the author of the ambiguity or contradiction. The 1973 amendment which awards excess assets to members upon termination of the plan is countered somewhat in the text in the method of financing section, by a nondiversion clause that permits, after all liabilities under the plan have been satisfied, property remaining in the plan as "erroneous actuarial computation" to be distributed to the company. This raises two legal questions:

First. The method of financing section deals primarily with the ongoing administration of the plan. This paragraph discusses only principal and income diversion. It does not discuss surplus, it does not discuss surplus upon termination which is specifically delineated in the termination section of the plan.

We believe the nondiversion clause in this instance has no standing.

Second. The aforementioned 1973 amendment awarding surplus funds to members, itself, creates a liability that we believe must be satisfied before any "erroneous actuarial computation" can be considered.

The plan further contains a right to amend paragraph giving the board of directors wide powers to change most anything provided all liabilities to members have been met. We believe the paragraph awarding excess assets to members upon termination is itself a liability which therefore cannot be amended out of the plan. Since it has been admitted that the plan to terminate was known on the date of the board action of June 26, 1981, declaring excess assets upon termination would thereafter revert to the company, we believe said action did not constitute a legitimate amendment but rather a necessary first step in a two-step scheme to seize the surplus.

Sixth. "Erroneous actuarial computation" requires more definition. IRS defines this as the difference between estimated monetary requirements and actual monetary requirements upon liquidation of a pension plan. The company takes the position this is the total difference existing in the fund. We believe this interpretation is far too broad and that the surplus is not "erroneous actuarial computation" but rather the direct result of several things; namely:

First. The unnecessarily conservative actuarial assumptions used as the basis for funding contributions by the prior A&P managements over many years.

Second. The reduction, in recent years of total company employment from more than 125,000 employees to less than 50,000 employees.

Third. Management's steadfast refusal to improve benefits or index the plan as income from high interest rates increased the known surplus, and eliminated need for current corporate contributions, and finally, the sudden decision to terminate the plan.

All prior and ongoing actuarial assumptions have been based upon the reasonable and proper assumption that a plan will continue indefinitely. This is customary and necessary. The company can now not logically plead that the surplus created by this sudden termination can be attributed to "erroneous actuarial computation."

There are several other facets of this case which deserve mention at this time. There is a current corporate cliche to the effect that "it is this or bankruptcy." Employees and others are led to the belief that diversion of the plan is necessary for corporate survival.

Actually, the continuing liquidation of A&P resulting from facility closings, while costing thousands of jobs, has also converted many millions of dollars of inventory and other assets into cash. The chairman, Mr. Wood, is quoted in the Wall Street Journal of May 10, 1982 as saying, "A&P is a smaller company, but is in a good position to produce a profit from continuing operations." The article adds:

> At year end, A&P's cash and short-term investments totaled $55.6 million. The addition of more tax-free cash from the pension surplus will result in a company with a most attractive and enviable cash position despite recent reported losses.

As owner of more than half of A&P stock, Mr. Haub's share of the profit gained through the planned seizure of the pension surplus will closely approximate his total prior investment in A&P. Thus, you would have a company with annual revenues in excess of $5 billion, bought with the funds in its own employee pension plan. Certainly, pension law was not intended to encourage or permit that.

Ironically, the three primary beneficiaries of this scheme, Mr. Haub, his wife Helga, and his personal confidant Rosemary Baumeister, who are both directors of A&P and named defendants in the papers filed on October 30, 1981, have been dropped from the list of defendants in the papers presently before the court.

We are told this is because it has been impossible to find them either in Germany or the United States over the past 7 months, and so, complete service of necessary court papers.

All this while the Haubs are in constant direct communication with A&P headquarters and you can rest assured that the benefits of the millions of dollars taken from this fund will find their way to that secret Bavarian hideaway within 7 hours.

To that we say: Wake up, America, before it is too late.

A&P Chairman, Jim Wood, at a recent meeting of company officers discussing the pension fund diversion is reported to have said, "Gentlemen, what I have managed to pull off here will go down in business history as the biggest coup of the century." That statement may well be correct, even if my quote is not precisely accurate.

Mr. Chairman, on behalf of 30,000 appreciate members of the A&P pension plan and others similarly situated, I wish to thank you and the committee for the invitation to appear before you and for your patience and attention in hearing this testimony and to tell you that we need your support.

Thank you.

The **Chairman**. The three of you have given us a sad, if not a sordid story.

Man's inhumanity to man affects countless millions more. All those people who were anticipating having funds for their benefit when they retired were totally deprived in both cases, of those funds. While there is a 10-year period involved before you can receive benefits at 65; however, they are potentially yours, when you do get to be 65 or whatever is the retirement age, to take that away seems to me to be a gross wrong.

You may want to inquire first of the Department of Labor and PBGC as to why they haven't taken some action. Do they think the law is inadequate? Did those companies do what was technically permissible? If so, they should recommend to the Congress some improvement in the legislation so that that kind of abuse could not be perpetrated. Apparently Congress has received no such request, to my knowledge from either one of those agencies.

Let me just ask two or three questions.

Ms. Little, were you originally consulted about the effect of the termination of the defined benefit plan and the subsequent establishment of the employees' stock plan and is this subsequent plan as good as the previous plan?

Ms. LITTLE. No, Mr. Chairman, we were not.

The CHAIRMAN. Were you consulted?

Ms. LITTLE. No, we were not consulted. We were advised after it happened.

Ms. CAFIERO. I would like to add that we requested many times to meet with management to get some better information. We were told that our specific questions would be answered but no other information would be forthcoming.

The CHAIRMAN. Mr. Harwood, your testimony is almost suggestive of a form of corporate blackmail, with the employees the ultimate losers in the scheme. What do you think the management should have done? Please comment.

Mr. HARWOOD. Well, if there was a proper reason for acquiring this stock, and the reason given was—a publishing house has added strength if it is independent and not part of a conglomerate structure, and if this stock were over-hanging the market and it was likely to get into the hands of a conglomerate to the disadvantage of the corporation, the company could have acquired that stock on the open market. It could have offered a tender for an accumulation of stock and probably accomplished the same purpose at a much lower price.

Mr. DAUB. Do you mean taking it back to the treasury of the company?

Mr. HARWOOD. That is right, and for resale in the future possibly, but at least taking it back to the treasury of the company.

The CHAIRMAN. Mr. Walsh, did you think that A&P needed the $200 million in order to continue its corporate existence, and do you feel other companies may take a similar route if volunteer termination of plans is permitted.

Mr. WALSH. Mr. Chairman, I personally do not believe there is any necessity for A&P to take this money in order to continue to survive. I think more important is that the position of the company is as quoted in the business press. The company indicated, certainly as any company would, that anytime you can get $200 million in cash—and in this instance, it becomes tax-free cash because of previous tax loss carry-forward, it is very, very significant and quite important. Necessary, no.

The CHAIRMAN. I agree with your assumption.

Mr. WALSH. Do I think other companies—other companies are certainly watching this closely and Mr. Chairman, this case is under litigation and we do not know where it will end.

The CHAIRMAN. I agree with your assumption you expressed earlier, that that fund belonged to these employees under the terms of the plan. That is they were to become beneficiaries in accordance with the requirements of the plan. That money should have been totally outside the control of the company other than to implement the plan.

If you were an employee—as I say, I think it was a part of the promise made. You got so much salary and you got a participation in a pension plan. If they had wanted your services, they would have told you.

One of the advantages of working for the company is: we have a good pension plan for the employees. That is part of the consideration for your work. Now, to have them regard that sum of money for which all these people had a wholesome and I think a legitimate expectancy as their own, to be done with as they pleased, seems to me to be a complete violation of their moral obligation and as you say there, many times that promised assurance that those funds would go only for the benefit of the employees.

I can't imagine the courts of this country not recognizing the equitable right of those people to the protection of that fund and that the company has put it beyond its personal beneficial control. The only obligation it has is to carry out the terms of the agreement.

They made a commitment, like declaring a truce. When you have made a valid declaration of trust of a certain sum of money, it is out of your hands as far as your personal aggrandizement is concerned. And it is the law. You have properly challenged the attention of the Congress. If that isn't a violation of the law and if it doesn't give PBGC or the Department of Labor the duty to act—not only the right to act but the duty to act—it is time Congress took proper cognizance of that fact.

Mr. **Harwood**. Mr. Chairman, I want to correct what might be an erroneous impression. The Harper plans, both the pension plan and the profit-sharing plans, could be terminated by the conditions of the original contracts. So you are quite right in emphasizing the moral obligation rather than the legal obligation.

Furthermore, in the Harper case all vested interests were properly covered but that in itself is small comfort to the person who has not yet acquired a large vested interest, but is looking forward to his retirement in 10 or 20 years.

The **Chairman**. There is a principle of law known as estoppel. Sometimes you are estopped by virtue of this condition, inducing reliance on what you have indicated, you are estopped to assert even a technical right you possessed. Now they might have preserved the technical right to convert these funds back into corporate funds. On the other hand, I think the continuity of the plan year after year, the people relying upon it, they weren't accentuating to their employees' attention, I imagine, that they have a right to eliminate this plan whenever they wanted to.

I believe you could assert the principle of estoppel. You have legally, based upon an equitable principle, you are estopped, after leading these people to believe that this fund is for their benefit, not yours, to assert the technical reservations that you made, that you can convert.

Mr. **Walsh**. Mr. Chairman, I would add one thing. With the wording in the actual text, the amendment put in this plan in 1973, at which time there was a surplus, and at which time there was some $30 million surplus, and the question being asked, and the management of this company decided to answer that question once and for all and proclaim that all surpluses upon termination were to go to the members and their beneficiaries, if that plan is not safe, there is no plan in the United States safe.

The CHAIRMAN. What is the legal status of any suit now pending?

Mr. WALSH. The suit is in a very delicate legal status, Mr. Chairman.

The CHAIRMAN. Before what court is it?

Mr. WALSH. Before the Federal court in Newark, N.J., and the delicacy arises because the A&P has made an offer of $50 million plus legal fees and the attorneys for the class, over our very strenuous objection, have indicated to the court that they feel this is a fair and proper settlement.

I spent 2 hours before the judge last Tuesday, and expressed my very strong objection to the settlement as proposed. The court has not ruled on the adequacy or inadequacy of the settlement but has decided as of this moment to send the settlement out as a notification to each and every member of the class and to set a court hearing—the date was set for July 9. I don't know if that date will apply.

The CHAIRMAN. I would hope, if it can be done consistent with the interests of the employees as they see that interest, if that case could go on up to the U.S. Supreme Court.

Mr. WALSH. We intend to take it there.

The CHAIRMAN. I think the courts of this country will be shocked by that kind of inequitable action on the part of these corporate bodies.

Mr. Daub?

Mr. DAUB. Mr. Chairman, I am certainly interested in the commentary. I have read carefully the testimony of the witnesses on this panel. As a lawyer it is my practice never to oppose witnesses when what they may say may be used in a court in cases under current litigation. I don't think we should try your case here in this hearing room.

The CHAIRMAN. Thank you, Mr. Daub.

Mr. Hendon.

Mr. HENDON. I would just like to thank my good friend and neighbor, Mr. Harwood, and the folks who came with him today from his company and other companies.

I am not a lawyer like my colleague, Mr. Daub; I am not a lawyer. I will just say I hope you clean their clock in that lawsuit, my friend.

The CHAIRMAN. Ms. Little, thank you so much, Mr. Walsh and Mr. Harwood. Thank you. You have been very helpful.

The CHAIRMAN. We will next hear from Mr. Edward A. Miller, a vice president of Harper & Row.

STATEMENT OF ED MILLER

Mr. MILLER. Mr. Chairman, I am Ed Miller, vice president and general counsel of Harper & Row Publishers, Inc. I am honored to appear before you to address the recent acquisition by Harper &

Row of its stock from Minneapolis Star & Tribune Co. and the related transactions involving the Harper & Row employee benefit plan as they pertain to the inquiries of this committee with respect to the funding of pension plans. We at Harper & Row are very proud of the recent steps we have taken to provide our employees with a one-third interest in our "house" while maintaining Harper & Row's status as an important and growing independent publishing firm.

Harper & Row established a retirement plan for its employees in 1939. The plan, as last amended, provided a maximum retirement benefit of 40 percent of an individual's average annual compensation over the highest 60 consecutive months of employment less 40 percent of the individual's primary Social Security benefit. The plan's funding assumptions were based on long-term factors which took into consideration both investment return and expected increases in salaries.

On May 1, 1980, based upon the plan's 7-percent interest assumption for actuarial funding purposes, the present value of all accrued benefits were approximately $9.4 million while the market value of the retirement plan's assets was approximately $13 million.

The CHAIRMAN. Mr. Miller, we are running a little short of time. We have one more panel here. Could you submit your statement for the record and then summarize what you wish to say?

Mr. MILLER. I will try to make it brief.

The CHAIRMAN. Without objection, your statement will be received and carried in full in the record.

Mr. MILLER. In February, 1981, Minneapolis Star & Tribune, then owner of approximately 33 percent of the outstanding Harper & Row common stock, advised the Harper & Row board of directors of its intention to dispose of its stock in Harper & Row. Because of the significant block of stock owned by Minneapolis Star & Tribune and the potential impact of such a disposition, the board of directors considered various alternatives.

These alternatives included assisting Minneapolis Star & Tribune in finding a buyer for its Harper & Row stock; arranging a sale or merger of Harper & Row; and purchasing the Harper & Row stock from Minneapolis Star & Tribune, provided the purchase could be financed without impairing the financial condition of Harper & Row.

The board, in connection with its deliberations, appointed a committee of outside independent directors, independent committee, to separately consider and make a recommendation to the board with respect to the possible acquisition by Harper & Row of its stock and related transactions. A letter from one of the independent committee's members, the distinguished social scientist Dr. Kenneth Clark, is attached to my testimony, and I ask that it be included in the record of this hearing.

The board and the independent committee concluded that an important reason for Harper & Row's success was its reputation as an independent publishing house. After analyzing all relevant factors and after receiving the advice of legal and investment counsel, they concluded that it would be in the best interest of Harper & Row and its employees and shareholders for Harper & Row to take advantage of the opportunity to purchase shares from Minneapolis Star & Tribune and to create a new employee stock plan.

The proposal, as recommended by the board and the independent committee, included the following steps: (1) termination of the Harper & Row Retirement Plan and the use of the assets in the Harper & Row Retirement Fund to provide for all accrued benefits under the plan, both vested and non-vested; (2) receipt by Harper & Row of the excess assets in the retirement fund, after providing for all accrued benefits; (3) use of such excess assets to finance, in part, the purchase of stock from Minneapolis Star & Tribune and the contribution of the bulk of that stock to a newly created employee stock plan.

The balance of the financing was to come from (1) the sale of certain nonessential real estate; (2) the use of cash on hand and borrowings under existing bank credit agreements; and (3) the purchase of Harper & Row stock with 50 percent of the profit sharing plan's assets.

The termination of the retirement plan was expressly permitted by the terms of the plan and by the regulations of the Pension Benefit Guaranty Corporation. In accordance with those regulations, all accrued benefits of participants of the plan, both vested and nonvested, were funded through the purchase of guaranteed annuity contracts issued by Prudential Life Insurance Co. which provided for annuities for all participants except for those participants with small accrued benefits who were to receive cash. The purchase price from Prudential of approximately $6.4 million, for all accrued benefits, was based upon the then current long-term interest rates.

Both the PBGC and the Internal Revenue Service approved the retirement plan's termination. All participants, including union participants, and district 65, were given notice of the proposed termination. District 65 communicated with the PBGC prior to PBGC's approval of the termination.

Under the law, the excess assets of a pension plan on termination may revert to either the employees or the employer depending on the express terms of the plan document. Pursuant to the express terms of the Harper & Row Retirement Plan, the excess assets, after providing for all accrued benefits, reverted to Harper & Row, and were available for any legitimate corporate purpose.

As noted above, these excess assets were used to purchase stock from Minneapolis Star & Tribune, the bulk of which was then contributed to the new employee stock plan, giving the employees a substantial minority interest in the company for which they work. This is a purpose officially encouraged by government policy and singularly appropriate in a business such as ours where the efforts of individual employees are particularly important to the success of the enterprise.

The employee stock plan was designed as a stock bonus plan, a form of ESOP under ERISA, the primary purpose of which is to invest in employer stock. All of the Harper & Row stock acquired from Minneapolis Star & Tribune not purchased by the profit-sharing plan will be contributed to the employee stock plan. A group of Harper & Row employees worked in formulating the allocation of Harper & Row shares under the employee stock plan thereby insuring that all employees, and especially older employees, would be adequately provided for.

The carefully prepared allocation formula was explained in detail to all employees. Each employee received an initial minimum allocation of 23 shares of Harper & Row stock for each $1,000 of compensation. The employee stock plan satisfied the requirements of the board and the independent committee that Harper & Row employees be covered under an attractive employee benefit plan which would be favorable to employees and would enable employees to share in the growth of Harper & Row. In addition, the board and the independent committee believed that the employee stock plan would create an important new identity of interest between employees and shareholders that will be of great benefit to all concerned.

The substantial number of shares to be contributed to the employee stock plan, 865,045 shares representing approximately 85 percent of the shares purchased from Minneapolis Star & Tribune, as well as the prospect of substantial appreciation were significant elements supporting the determination that the interest of Harper & Row and its employees have been well served by the purchase and the establishment of the employee stock plan.

The employees in our judgment are substantially better off under the new plan. The improvement is dramatic in the case of employees represented by district 65, which represents approximately 15 percent of our employees. For example, the average union employee has received initial benefits under the new plan more than 10 times greater than the benefit that employee would have accrued under the prior plan through 1986.

Harper & Row also maintains a profit-sharing plan. The profit-sharing plan was amended prior to the acquisition of the Harper & Row stock to permit investment in Harper & Row stock so that it qualified as an individual account plan under the provisions of ERISA. An individual account plan is not subject to the diversification requirements of ERISA with respect to the holding of employer stock.

Prior to such amendment the investments of the profit-sharing plan were divided between an equity fund and a fixed-income fund. As part of the amendments to the profit-sharing plan, the separate equity and fixed-income investment funds were eliminated. Immediately after the acquisition of the Harper & Row stock from Minneapolis Star & Tribune, 50 percent of the profit-sharing assets was used by the plan to purchase $1.75 million of Harper & Row stock from Harper & Row on the basis of the prevailing price of Harper & Row stock in the over-the-counter market as required by ERISA. The balance of the profit-sharing plan was invested in fixed-income securities.

It should be noted that the acquisition of stock from Minneapolis Star & Tribune by Harper & Row and the related transactions were fully disclosed in a proxy statement distributed to all shareholders. The shareholders overwhelmingly approved the acquisition of stock and the adoption of the new Harper & Row employee stock plan. So as not to influence the shareholder vote, Minneapolis Star & Tribune voted its shares of Harper & Row stock in the same proportion that other shares of Harper & Row stock were voted.

We are extremely proud that through our employee benefits plans our employees own a one-third interest in Harper & Row, proud enough to put every employee name on the cover of our next annual report. As a result of these transactions our authors are assured that our house will remain independent; our shareholders have the benefit of a more committed work force; and most importantly, our employees will now be able to participate in a meaningful way in the success of Harper & Row, bolstered by a tremendous new incentive for productivity and growth.

[Material submitted by Mr. Miller follows:]

CLARK, PHIPPS, CLARK & HARRIS, INC.,
New York, N.Y., May 24, 1982.

Hon. CLAUDE PEPPER,
Chairman, Select Committee on Aging,
Washington, D.C.

SIR: I understand that your Committee is examining steps recently taken by Harper & Row, including the termination of its retirement plan, the purchase of stock from Minneapolis Star and Tribune Company and the contribution of the bulk of that stock to a new Employee Stock Plan.

I was a member of the Board of Directors which considered these proposals and recommended them to the stockholders. I was also a member of an independent committee of outside members of the Board of Directors which separately passed upon the transaction.

I would like to affirm personally to the Select Committee that the Harper Board and its independent committee studied all aspects of the transactions, received advice from the Company's outside lawyers, investment bankers and accountants, and carefully considered their impact on stockholders, employees and authors. It is my considered judgment that the transactions which we recommended and which were approved by our stockholders were correct and in the best interests of the Company, its stockholders, employees and authors.

Very truly yours,

KENNETH B. CLARK

The **CHAIRMAN**. Thank you very much, Mr. Miller.

Mr. Miller, how long had this pension plan been in effect?

Mr. **MILLER**. I believe since 1939.

The **CHAIRMAN**. Now all during that interval, from 1939 up to—when was it this appropriation of funds occurred?

Mr. **MILLER**. The termination of the pension plan, sir, occurred I believe as of September 1981.

The **CHAIRMAN**. So from 1939 to 1981, this pension plan was in effect.

Mr. **MILLER**. Yes, sir.

The **CHAIRMAN**. Did it all through that interval provide that the company could at any time it wished to do so, terminate the plan?

Mr. **MILLER**. To the best of my knowledge, Mr. Chairman, it did.

The **CHAIRMAN**. Did the company at any time notify the employees to remind them that the company reserved that right.

Mr. **MILLER**. Yes, Mr. Chairman, they did.

The **CHAIRMAN**. Would you give us some assurance when they so advised the employees?

Mr. **MILLER**. In the employee benefit book.

The **CHAIRMAN**. That described the conditions of the plan.

Mr. **MILLER**. Yes, Mr. Chairman.

The **CHAIRMAN**. And they had the book during that interval?

Mr. **MILLER**. Yes, Mr. Chairman.

The **CHAIRMAN**. From 1939 to 1981.

Mr. **MILLER**. Well, I don't know——

The **Chairman**. Do you know of any instance where the company specifically said to the employees in substance: "We want all of you to understand, we have a right to terminate this plan at any time we wish to do so"? Do you remember any such instance?

Mr. **Miller**. Yes, within the employee benefit book. I am not aware of other occasions where that was said.

The **Chairman**. Is Mr. Harwood and the other witnesses correct in saying that the stock was selling at $3 or $4 a share over the counter and you all agreed to pay $20 for these shares that you bought; partially with this pension money?

Mr. **Miller**. Mr. Chairman, during the period of time that the board and the independent committee was considering these things, the stock traded between a price of about $12.50 and a price of about $10.50 and the board deliberated long and hard on these matters, sir, with the advice of Kidder, Peabody, our investment bankers and advice of our counsel.

The **Chairman**. And you paid about twice what the market was?

Mr. **Miller**. The range was $10.50 to $12.50 during this period of time and the price was $20 a share, sir.

The **Chairman**. Was it the opinion of the management at the time this plan was terminated, that it was for the best interest of the employees that the pension plan be terminated.

Mr. **Miller**. Yes, indeed it was, Mr. Chairman. It was the belief of the Committee that the price of the stock was a fair price under all the circumstances that they took into consideration and that this was an important opportunity to do something that was beneficial for both the shareholders and the employees.

The **Chairman**. And it is your company's position that what the employees got later was the equivalent of the potential that was taken away from them?

Mr. **Miller**. What they got later, Mr. Chairman, we believe is better.

The **Chairman**. Were they consulted?

Mr. **Miller**. Yes, indeed, sir, they were.

The **Chairman**. Did the employees vote on it?

Mr. **Miller**. No, sir, they did not.

The **Chairman**. Did you mean they really were consulted and given a chance to vote on your terminating the plan?

Mr. **Miller**. Mr. Chairman, we fully consulted with the employees from the beginning of this plan——

The **Chairman**. Were they given a chance to vote?

Mr. **Miller**. No, sir, they were not.

The **Chairman**. Now you didn't borrow the money. I can well understand you might have a chance to make an advantageous purchase of stock. The company wanted to buy and thought it would be for the best interests of the company to acquire. You might borrow from the fund, which was not to be used for some time in the future, and put in in place of it the stock that you bought, to the extent that the fund was used. You could have done that.

However, you chose not to borrow from the fund. You chose to terminate the pension program. Is that correct?

Mr. **Miller**. Yes, Mr. Chairman, and we have replaced it with something which we believe is better.

The CHAIRMAN. I say you did not borrow from the fund, you terminated the pension program?

Mr. MILLER. No, sir, we did not.

The CHAIRMAN. And took the money?

Mr. MILLER. No, sir, we did not.

The CHAIRMAN. You terminated the pension program and took the money and used it for stock purchase.

Mr. MILLER. Mr. Chairman, the money that was used for the purchase was after all of the accrued benefits had been paid.

The CHAIRMAN. About $10 million of those dollars came out of the pension fund?

Mr. MILLER. That was the excess assets after all of the accrued benefits had been provided for. All accrued benefits both vested and unvested.

The CHAIRMAN. Do you mean vested?

Mr. MILLER. Vested and nonvested. Vested and nonvested, Mr. Chairman.

The CHAIRMAN. Do you mean by that you anticipated what everyone could receive when he came to retirement age?

Mr. MILLER. We calculated the accrued benefits, as I understand it, in accordance with the provisions of the plan and in accordance with the regulations of the PBGC. We submitted all the information to them and they approved the termination.

The CHAIRMAN. I believe you said they did not vote, the employees did not vote to approve it?

Mr. MILLER. That is correct.

The CHAIRMAN. Did it ever occur to you that if you had a surplus maybe you might improve the plan a little bit in view of inflation?

Mr. MILLER. That was a possibility, Mr. Chairman. We thought that this was an opportunity for our employees that we thought was beneficial to them.

The CHAIRMAN. But you didn't consider that possibility. At least you didn't adopt that option.

Mr. MILLER. That is correct, sir.

The CHAIRMAN. Are there any suits pending in this case?

Mr. MILLER. Yes, sir, there are.

The CHAIRMAN. What is the status of those suits?

Mr. MILLER. One of them was filed in Delaware in December. That is a stockholder's suit. One of them was filed 2 or 3 days ago in New York and that is a suit by district 65.

The CHAIRMAN. Mr. Miller, you are an attorney and I am sure a good attorney. Do you perceive any inextricable condition on the part of an employer that will let people believe, or permit them to believe, from 1939 to 1981, that when they get out to a certain period they will be eligible for certain retirement benefits, and then assert the right to appropriate that fund at any time you want to for any corporate purpose to which you wish to direct it?

Mr. MILLER. All accrued benefits both vested and not vested were provided for in our termination.

The CHAIRMAN. Hadn't you already made an equitable commitment of those funds to your employees for the future? Hadn't you made an equitable commitment?

Let me ask you this: Suppose you had some money in escrow, in a bank. Would you have thought you could pull down those funds and use them to purchase this stock?

Mr. MILLER. Mr. Chairman, that money that was in escrow was there to provide for all benefits accrued up through September 1981 and it was used for that purpose.

The CHAIRMAN. I am asking you a legal question: If you had some money in a bank, put up as escrow, would you regard that money as available for you to take and appropriate to the purchase of some stock in the company?

Mr. MILLER. After it had been used for the purpose for which it was escrowed and if there was an excess, yes, I would consider that to be——

The CHAIRMAN. Well, did the employees agree that it was——

Mr. MILLER. I believe they did.

The CHAIRMAN. They didn't vote that way?

Mr. MILLER. No, sir.

The CHAIRMAN. Why didn't you have a vote? Didn't you think you would need the protection of a vote against a subsequent possibility of protest from the employees? Why didn't you take a vote?

Mr. MILLER. Mr. Chairman, we also had a vote from the stockholders and they overwhelmingly approved.

The CHAIRMAN. Those are your stockholders who presumably were to get the benefit and I understand from the other witnesses it was your handpicked board of directors that approved it. Is that true?

Mr. MILLER. Was the board of directors handpicked? Is that your question, sir? No, I don't believe that is a fair characterization of the board of directors.

The CHAIRMAN. Do you realize the importance to the country of a private pension system and program?

Mr. MILLER. Yes, sir.

The CHAIRMAN. Do you see a need for the integrity of those programs and plans, to be assured, and that people can rely upon them, and if you do, do you think it is good public policy for employers to insist upon the right to reach in and take back whenever they choose to do so, funds that they have publicly committed to their pension purposes? Do you think that is good public policy?

Mr. MILLER. Mr. Chairman, I am only speaking on behalf of Harper & Row and I am only saying I think what we did in this case was right.

The CHAIRMAN. You are answering as a lawyer, you are not here to give us an opinion on public policy.

Mr. MILLER. I don't want to answer on general public policy. I am answering my personal conviction that what Harper & Row did was correct and right.

The CHAIRMAN. May I suggest that you and we may have a different point of view? We, of course, respect the law, but at the same time I think it is our duty to observe the equitable considerations under public policy involved in these matters.

Thank you, Mr. Miller.

Mr. Daub?

Mr. DAUB. Mr. Chairman, we are all entitled to our own opinions but none to our own set of facts. In accordance with my own conviction, I don't want a single question that I might ask to be misinterpreted as approval or disapproval for what this company or any other company did as long as they are in litigation, so I will pass asking any questions, though I will follow the matter in the future and will possibly submit questions in writing.

The CHAIRMAN. Thank you very much, gentlemen.

PANEL FOUR, CONSISTING OF JEFFREY CLAYTON, ADMINISTRATOR, PENSION AND WELFARE BENEFIT PROGRAMS, DEPARTMENT OF LABOR; S. ALLEN WINBORNE, ASSISTANT COMMISSIONER, EMPLOYEE PLANS AND EXEMPT ORGANIZATIONS, INTERNAL REVENUE SERVICE, ACCOMPANIED BY BILLY M. HARGETT, DIRECTOR, EMPLOYEE PLANS DIVISION, AND IRA COHEN, DIRECTOR, ACTUARIAL DIVISION

STATEMENT OF JEFFREY N. CLAYTON

Mr. CLAYTON. Thank you, Mr. Chairman. I am happy to be before you today to discuss the impact of certain fiduciary provisions of the Employee Retirement Income Security Act, or ERISA. As you are aware, the Department of Labor has primary responsibility for enforcement of these provisions under Reorganization Plan No. 4 of 1978.

It is a responsibility which we take seriously. Over 90 percent of our investigators' time is spent on investigating fiduciary violations of ERISA. In fiscal year 1981, we restored or recovered $33.2 million through our fiduciary investigatory efforts.

The monitoring of the fiduciary activities of plans is a difficult job and one that is becoming even more difficult. Currently, there are about $600 billion in private pension and welfare plan assets. This figure is expected to grow to $3 trillion by 1995 according to one forecast prepared for the Department. As pension assets grow and become yet a greater percentage of this Nation's source of long-term capital, the competition for use and control of these assets will also continue to grow.

Thus, the Department will be faced with the ever-increasing responsibility of assuring that all of these funds are managed prudently and for the exclusive purpose of providing benefits to plan participants and beneficiaries. Such an approach will also assure that the free market allocates the funds in the most effective and efficient manner so as to provide the strongest possible economy.

There has been much discussion in recent years that pension funds should be invested for social purposes. This is a shorthand way of saying that a plan should be allowed to sacrifice a certain amount of investment yield if the investment is to further some otherwise desired objective. This committee, because of your special concern with the aged, recognizes better than many others that ERISA already has a social purpose, that purpose is to assure that funds are available to pay the anticipated retirement and other benefits of plan participants and beneficiaries.

Mr. Chairman, let me assure you that we will strongly enforce the fiduciary provisions of ERISA to insure that this purpose is carried out. Our Nation's retirement system is too important and has too many financial problems of its own to expect it to subsidize special investments which cannot stand on their own merits.

The pension fund is not for the use of the employer, nor is it for the use of the union; rather, it is to be used for the exclusive purpose of providing retirement benefits to all participants and beneficiaries. We will enforce ERISA with that in mind.

In recent months, a good deal of attention has been given to several situations where plan assets were allegedly not managed prudently and for the exclusive benefit of participants and beneficiaries.

I know this committee is especially interested in the situation involving the Grumman Corp. where the Department went to court to recover for the plan, among other things, assets lost by the trustees' actions in using the pension plan's assets to prevent a takeover of the company.

Also, as evidenced by your witnesses today, you are interested in the termination of the A&P and Harper & Row pension plans. Those terminations resulted in the company recovering substantial assets.

Since these situations involve matters which are, for the most part, currently in litigation or under investigation, and since they may turn on their own unique facts, I would rather not address them specifically.

Instead, I would like to explain our general approach to the application of ERISA's fiduciary provisions to the actions of the employer which sponsors the plan, and to individuals who are both plan fiduciaries and officers of the plan sponsor.

One important consideration in doing the analysis is the voluntary nature of the private employee benefit system in this country. ERISA provides certain protections for participants and beneficiaries if an employer has a plan.

It does not, however, require any employer to have a plan; nor in general, does it prevent him from terminating a plan. The decision of the employer whether or not to have a plan is not a fiduciary decision. However, other decisions by the employer may indeed be fiduciary decisions.

ERISA recognizes that the employer can play two roles, both as plan sponsor and plan fiduciary. Section 408(c)(3) of ERISA specifically provides that:

> Nothing in Section 406 shall be construed to prohibit any fiduciary from serving as a fiduciary in addition to being an officer, employee, agent, or other representative of a party in interest.

It would seem to follow from this that ERISA envisions that there are times when the fiduciary can take off his fiduciary hat and act as an officer of the company.

Assessment of his conduct requires deciding when he is wearing his fiduciary hat and whether and when he may properly wear his company officer hat.

It is hard to generalize, since every case depends on its special facts. It is clear that a person wears his fiduciary hat when he directs the use of plan funds. For example, if he causes the plan to purchase a certain stock, whether it is to aid the sale of the company or the avoidance of a takeover, he is wearing his fiduciary hat.

Such activity must satisfy the fiduciary rules of ERISA, including acting prudently and for the exclusive purpose of providing benefits for participants and beneficiaries.

In situations, however, where the corporate officer, although he is also a fiduciary of the plan, is not causing the plan to do anything, or in general is not conducting any activities that cause him to be a fiduciary, his actions may not be fiduciary activities and thus, he may not be subject to the ERISA rules of conduct.

We have seen recently situations where employers have terminated plans in order to recover the extra assets of the plan that resulted from overfunding. As discussed above, ERISA in the absence of special circumstances, allows employers to terminate a plan.

It also allows employers to receive plan funds by reversion in certain circumstances. The specific facts of any case, however, may result in a fiduciary violation.

Thus, I would not want my remarks today to be interpreted as general approval of all such situations. Nevertheless, one must recognize that one consequence of a voluntary system must be the freedom to terminate plans.

One last issue I understand is of concern to you is the role of the actuary. The Department in Interpretive Bulletin 75-5 made clear that in our view, professional service providers such as attorneys, accountants, and actuaries are not to be considered fiduciaries when they are merely performing their usual professional functions, unless the factual situation of the specific case indicates that they were carrying out activities that would bring them within the definition of a fiduciary.

We believe this general rule is a sound one and we continue to adhere to it; applying it, of course, on a case-by-case basis as the facts may warrant.

I would be happy to answer any questions.

STATEMENT OF S. ALLEN WINBORNE

Mr. WINBORNE. Mr. Chairman and members of the select committee, I am pleased to appear before you today in response to your request for testimony by the Service on the four items included in your letter of April 27, 1982.

They are: One, the Service's review of the termination of the A&P employees' retirement plan; two, the Service's investigation of the termination of the Harper & Row Publishers, Inc. plan; three, the minimum funding requirements of the code, and, four, the Service's review of the Form 5500, Schedule B, Actuarial Information.

Accompanying me this morning are Billy M. Hargett, Director, Employee Plans Division, and, on my right, Ira Cohen, Director, Actuarial Division.

Before I address the specific concerns of the committee, I will first summarize some of the provisions of the Internal Revenue Code intended to protect the interests of participants and their beneficiaries in private retirement plans and then discuss the efforts of the Service to obtain compliance in these areas.

Among the provisions that are relevant to the committee's expressed concerns are:

First. Funding requirements of the code, which require any employer maintaining a qualified pension plan to make a minimum level of contributions to the plan under a funding method selected by the employer.

Second. A plan must be operated for the exclusive benefit of employees, which generally precludes the reversion of plan assets to the employer. However, when a defined benefit pension plan terminates, the assets may revert to the employer to the extent that they exceed the amount needed to provide all plan benefits whether or not vested.

Third. Except in limited circumstances, the employer is not permitted to amend the plan to retroactively reduce employee benefits accrued under the plan. In the aggregate, these requirements assure that plan assets will not be returned to the employer before promised benefits are paid, but at the same time allow an employer flexibility in determining the level of contributions to be made to the plan.

Compliance activities—Our compliance activities with respect to employee plans are conducted through three basic programs: The rulings program, the determination program, and the examination program. The rulings program has only a limited relationship to the specific concerns that have been raised by the committee, and therefore, I will focus my discussion on the determination and examination programs.

Determination program—Generally, under the Service's determination program, our key district offices review plans voluntarily submitted to determine whether the plans meet the requirements for tax benefits under the code. Employers and other plan sponsors are permitted to apply for such a review when the plan is initially adopted, amended or terminated. This program is very helpful to affected taxpayers because they may obtain answers to many complex issues by requesting a determination letter. Taxpayers generally request a determination letter because having a favorable determination letter provides substantial protection against the retroactive loss of tax benefits in certain cases.

The determination program alone is not sufficient to assure that all plans meet the requirements of the Code because:

First. The determination program is voluntary, that is, a plan sponsor is not required to request a determination letter.

Second. The plan in operation may not satisfy the requirements of the code. Also, the determination program does not address the minimum funding requirements of the code.

Examination program—The Service's examination program complements the determination program and permits the Service to ascertain whether a plan is operating in compliance with the requirements of the code.

The Service examines approximately 15,000 retirement plans annually. Plans are selected for examination in several ways. For example:

First. Employee plans examinations are generated by referrals from Internal Revenue agents who question a deduction for contributions to a plan during an income tax examination. Such cases are referred to an employee plans specialist.

Second. We receive information from the Department of Labor and the Pension Benefit Guaranty Corporation which assists us in determining whether an examination should be undertaken.

Third. We also conduct examinations as a result of special projects. For example, we have been looking at those plans which, according to our records, have not been amended to meet the requirements of the Employee Retirement Income Security Act of 1974, ERISA. In addition, we recently completed our taxpayer compliance measurement program (TCMP) under which we examined a cross section of 18,000 plans, which should assist us in developing criteria for determining which plans should be selected for examination in future years.

Most of our examinations result from the classification and selection of returns at the IRS centers. During our classification process, we select a cross section of various sizes and types of plans for examination. We also attempt to select a sample of plans with certain characteristics, such as employee stock ownership plans and plans that have terminated. Because of limitations of resources available to conduct our examination program, we give priority to the examination of plans that we believe have a significant probability of noncompliance with the requirements of the code.

Plan terminations—Because you expressed a particular interest in plan terminations, I will now discuss the Service's efforts in the last 2 years to upgrade the quality of our determination and examination programs.

The Service's continuing professional education courses for employee plans specialists emphasize issues arising in plan terminations. Last year, we formulated a detailed explanation to assist employee plans specialists in identifying terminating plan problems, as well as a detailed plan termination standards worksheet that must be completed on each case.

In April of this year, we issued a terminations handbook which incorporates the termination worksheet and the detailed explanation plus additional explanatory material for use by employee plans specialists when reviewing plan terminations, during both the determination and examination process. The handbook also explains the actions to be taken by the specialists when information provided by pension plans requesting a determination upon termination is incomplete or inconsistent and identifies the supporting documentation which should be obtained when qualification issues are identified.

Actions taken by employee plans specialists concerning termination cases—both determination and examination—are now reviewed by a special technical staff in our key district offices.

As I previously mentioned, an employer terminating a retirement plan is not required by law to file an application for determination with the Service. However, if an employer does file an application, the Service will issue a determination letter stating whether the termination of the plan does not affect its qualification for Federal tax purposes.

A favorable determination letter will be issued to a terminating plan after the Service is satisfied that, among other items: First, the terms of the plan and trust meet the qualification requirements of the code——

The CHAIRMAN. Would you tell us what the qualifications are?

Mr. WINBORNE. The qualifications requirements primarily are the participation rules, the rules against discrimination, the proper vesting rules. Those are generally the requirements which qualify a plan for tax purposes.

The CHAIRMAN. Do they relate to immoral or inequitable conduct?

Mr. WINBORNE. Immoral or inequitable. Well, certainly the discrimination rule is primarily intended to prevent the plan being drafted in such a way that it discriminates against the rank and file in favor of the owners or highly paids, or stockholders or officers, and so forth.

That is an answer to your question, I hope.

The CHAIRMAN. When pension funds that might subsequently be enjoyed by employees are taken away from the, I would regard that as an inequitable depradation of a potential benefit.

Mr. WINBORNE. If they are taken away improperly, I would agree with you, Mr. Chairman, but I must throw in the record improperly, because certainly every case can be different.

The CHAIRMAN. Go right ahead.

Mr. WINBORNE However, if an employer does file an application, the Service will issue a determination letter stating whether the termination of the plan does not affect its qualification for Federal tax purposes.

A favorable determination letter will be issued to a terminating plan after the Service is satisfied that, among other items:

First. The terms of the plan and trust meet the qualification requirements of the code.

Second. The assets of the plan have been used for, or diverted to, purposes other than the exclusive benefit of the employees and the beneficiaries prior to the satisfaction of all plan liabilities.

Third. The plan had no operations defects, such as prohibited discrimination, that would cause it to fail to meet the qualification requirements.

Fourth. The plan has been a permanent and continuing program of the employer.

Fifth. The rights of all affected employees to benefits accrued to the date of the termination, to the extent funded, are fully vested, and,

Sixth. Only the assets in excess of those required to satisfy all liabilities with respect to employees and their beneficiaries may revert to the employer.

Specific committee concerns:

Having discussed the efforts of the Service to obtain compliance with the provisions of the code that are applicable to qualified plans, I will now address the specific concerns of the committee.

You have asked whether the Service will review any settlement reached in the litigation involving the termination of the A&P plan to determine whether applicable requirements are being met regarding the termination of the plan and any potential partial termination due to the layoff and termination of A&P employees over the last several years.

We are aware of the issues raised in the case of *Walsh* v. *The Great Atlantic and Pacific Tea Company, Inc.*, concerning this plans, and we have discussed the allegations contained therein with appropriate officials in the IRS Newark key district. Any review of the settlement by the Service would be conducted in the context of the consideration of an application for determination or an examination of the plan. I can tell you that the Service has no record of receiving for determination upon termination from the A&P plan. However, because of the confidentiality provisions of the code, we are not permitted to state whether the Service is conducting or intends to conduct an examination of the plan or the results of any such examination. We can assure you, however, that, just as it would with any other similarly situated employee plan, the Newark key district will consider any information that comes to its attention about the A&P plan, such as information about the settlement of the lawsuit, when it selects employee plans for examination.

The Harper & Row Publishers, Inc., pension plan applied for a determination from the Manhattan District Office on September 1, 1981. The application shows, among other things, that there was not a substantial decline in the number of employees covered by the plan and that the assets under the plan exceeded the plan's liabilities to the employees and their beneficiaries. Based on its review of the request, the district determined that the reversion to the employer did not violate the requirements of the code. Copies of the determination letter request and related documents have previously been provided to the committee.

The third and fourth items for which our testimony has been requested concern primarily actuarial matters involved in the funding of pension plans. Employers maintaining certain pension plans are required to make contributions to fund these plans in sufficient amounts so that at the end of each plan year ERISA's minimum funding requirements are satisfied. The Service has the responsibility for determining whether these minimum funding standards have been met. In this regard, a funding standard account which measures actual contributions against required contributions must be maintained for each of these plans.

For a defined benefit plan subject to ERISA's minimum funding requirements, actuarial data including this funding standard account must be reported each year on a schedule B. This information, along with other information on the plan, is reviewed in conjunction with our examination program. In addition, compliance with ERISA's minimum funding standards is further enhanced by the availability of each plans' schedule B for public inspection after it has been filed with the Service.

Under ERISA, the minimum level of contributions is dependent upon the particular funding method and actuarial assumptions selected by the employer. Because an employer has considerable flexibility in the choice of funding methods and actuarial assumptions, the employer's choices have a significant impact on the determination for any plan year of the amounts necessary to satisfy the minimum funding standards.

Furthermore, ERISA's minimum funding requirements do not mandate, and consequently do not guarantee, that a plan will be funded to the extent that the value of a plan's assets will at all times equal or exceed the value of the benefits that have been earned to date or even those that have become vested. Thus, the Service does not have authority to require a level of funding that would result in the value of plan assets being at least equal to the value of benefits accrued.

In the course of conducting field examinations, the key district offices review plan funding methods, actuarial assumptions, and plan experience to assure that contributions are sufficient to satisfy the minimum funding requirements and that deductions are not claimed for contributions in excess of the deduction limitations.

That concludes my opening remarks. Ira Cohen, who is a Fellow in the Society of Actuaries, an enrolled actuary, and also the Director of our Actuarial Division, has prepared an additional statement which covers more thoroughly the third and fourth items in your letter. Ira is available to read his statement, summarize his statement or answer questions, whichever the committee desires.

[The prepared statement of Ira Cohen follows:]

PREPARED STATEMENT OF IRA COHEN

Mr. Chairman and members of the select committee: I am pleased to appear before you today to present testimony related to the funding of pension plans. The third item for which testimony was requested concerned the Code's minimum funding requirements for pension plans and the effectiveness of such requirements in ensuring that pension plans are adequately funded. In this regard, ERISA's minimum funding standards require an employer to make contributions to a plan that are determined under a funding method that is selected by the employer. The contributions for each plan year are required to be sufficient to pay the normal costs of the plan determined under the funding method selected and, if there are unfunded past service liabilities for the plan under this funding method, to pay additional amounts, past service costs, to amortize over a specified number of plan years these unfunded past service liabilities. A plan's unfunded past service liabilities can result from retroactive benefit increases, such as provided under a plan for an employee's service prior to the adoption of the plan or of a plan amendment increasing benefits. If contributions to the plan for a plan year are not sufficient to cover these costs, the plan may have an accumulated funding deficiency, and the employer may be subject to an excise tax.

On reading the ERISA funding requirements, it is possible to get the impression that the factors used in determining the contributions under a plan's funding method (and thus in determining whether the plan satisfies the ERISA funding requirements) are precise. The standards call for specific charges and credits to a funding standard account, with specific amortization periods for several of these charges and credits. However, this impression is misleading. Rather the minimum costs required under the funding standards in any plan year are dependent upon decisions of the employer and the enrolled actuary for the plan.

An actuarial valuation determines the level of systematic contributions necessary to provide the benefits under the plan. Actuarial assumptions are used to estimate the total amount of assets that will be necessary to pay all benefits under the plan. For example, an assumption is made about mortality, that is the likelihood that a participant will die. For a plan participant in pay status, the monthly benefits have already been determined. However, each future payment may be conditioned on the participant surviving to the due date of the payment. To determine the present value of the plan's liability for the participant any such payment must be discounted by the probability of death before such payment is due. The amount of benefits payable in the future is also discounted for interest, in order to assign a present value to a future liability. The benefit of an employee who is currently working may vary with the amount of future service. In addition, plans often provide that benefits are forfeited when an employee separates from service prior to a stated number of years of service. Such forfeitable benefits are called nonvested benefits. Thus, the level of contributions to the plan is also affected by an assumption about future employee turnover. If a plan provides subsidized early retirement benefits (That is, benefits in excess of the actuarial equivalent of the portion of the normal retirement benefit accrued at the date of early retirement), plan costs will vary with assumptions about the age of retiring employees.

An error in the actuarial assumptions used by a plan can have a substantial effect on the plan's costs. The selection of a mortality assumption is generally not too significant. However, the costs may vary significantly with the choice of interest rate. An acturial rule of thumb (which is inaccurate in some cases) is that costs decrease approximately six percent for an increase in the interest assumption of one-fourth of one percent. The rule of thumb tends to break down with large interest differentials. As one can see, however, the bottom line costs vary significantly with the choice of the actuarial assumptions. One important question is how the law permits the Service to deal with actuarial assumptions.

The Code states that all pension costs must be determined on the basis of actuarial assumptions and methods that are reasonable in the aggregate (taking into account the experience of the plan and reasonable expectations) and which, in combination, offer the actuary's best estimate of anticipated experience under the plan. The House Committee Report concerning ERISA indicates that the Service can retroactively change the actuarial assumptions when it audits a plan only where the assumptions are substantially unreasonable. This position is not inconsistent with the Service's pre-ERISA position concerning deductions for pension contributions. Under that position, the actuarial assumptions will generally be considered reasonable unless there is a consistent pattern of substantial gains from sources that are likely to recur. A "gain" means that the costs actually experienced by the plan are less than the costs that were estimated. The words "consistent," "substantial," and "likely to recur" are similar to the requirements in the legislative history of ERISA. Therefore, our ability to challenge a plan's actuarial assumptions is limited to situations where the assumptions are substantially unreasonable.

Perhaps the most sensitive actuarial assumption in the case of any plan is the interest rate. The interest rate reflects the likely return on all assets (including future contributions) over a long period of years. It is very difficult for the Service to challenge an interest rate assumption when the differential is only one-half of one percent, yet that differential significantly impacts on costs. The House Committee Report clearly recognized that there is a range of actuarial assumptions that may be reasonable and indicates that the choice of the assumption should be left to the actuary.

A second item in the actuarial valuation significantly impacting on the minimum funding requirements is the choice of funding methods. Fundings methods are a device to determine how plan contributions needed to pay the value of benefits determined under an acturial valuation will be spread over a period of many years. Stated differently, funding methods are a device used to allocate costs to plan years. Under some funding methods, the costs for a particular plan year could be more than twice as great (even using the same actuarial assumptions) as the cost under another funding methods. ERISA describes six acceptable funding methods and also permits other methods found acceptable by the Service.

There is a further provision in the law that allows the sponsor of a plan great flexibility in satisfying the minimum funding requirements. The Code provides that contributions made after the end of the year may relate back to that year in terms of satisfying the plan's minimum funding requirements. Under temporary regulations issued by the Treasury Department, such retroactive contributions can be made up to 8½ months after the end of the year.

To sum up, the taxpayer has considerable flexibility in the choice of funding methods and actuarial assumptions which could have a significant impact on the determination for any plan year of the amounts necessary to satisfy the minimum funding standards and in the timing of the plan contributions to satisfy such.

The Service cannot challenge the choice of methods if it is permitted under ERISA. In addition, the Service cannot challenge the actuarial assumptions used by a plan unless they are substantially unreasonable. The Service can assess an excise tax if a plan that is subject to Code section 412 has an accumulated funding deficiency. This can occur if such a plan uses an unacceptable funding method or unreasonable actuarial assumptions which produce costs lower than permitted by ERISA or if an accumulated deficiency occurs for some other reason, such as a failure of the plan sponsor to maintain an adequate level of contributions.

Are ERISA's minimum funding standards effective in ensuring that defined benefit pension plans are adequately funded? The answer to this question involves the concept of actuarial soundness. There is no university accepted definition of actuarial soundness, even within the actuarial community. For discussion purposes, however, the term could be defined as a level of assets sufficient to provide benefits that will become due within a specified number of years, after allowance of future interest assumed to be earned by the fund and future contributions assumed to be made to the fund. Thus, under this definition actuarial soundness would merely be a projected cash flow test over some interval of time.

The Service does not have authority for requiring that a pension plan's funding be actuarially sound. The qualification requirements of the Code do not deal directly or indirectly with the concept of actuarial soundness. Although the minimum funding requirements require a basic level of contributions to a pension plan of normal costs and past service costs as mentioned previously, these requirements do not guarantee actuarial soundness.

A plan that always satisfies the minimum funding standards may, nonetheless, be unable to provide benefits when they become due for a rather limited period of time. Consider, for example, a plan whose assets are substantially smaller than the present value of retirement benefits. ERISA's minimum funding standards could require that the annual contributions for that plan merely be adequate to amortize that unfunded liability over 30 years. However, all the benefits would be paid out to the retirees over the remaining period of their lives, and their life expectancy may be only 15 years. Further, assume that the active population is small relative to the retired population. In such a case, benefits that are payable during a plan year may well exceed the contributions required to satisfy the minimum funding standards for that year.

At this point several questions may come to mind. If the minimum funding standards do not insure actuarial soundness, why were they enacted? Why wasn't an actuarial soundness test enacted? Isn't actuarial soundness a more socially desirable goal?

Clearly, actuarial soundness is an important goal. Historically, retirees have lost benefits because the accumulation of assets in pension plans have been insufficient to provide benefits, not because of a failure of pension plans to satisfy a minimum funding standard. Before analyzing the intricacies of an actuarial soundness standard, it should be recognized that there are different and competing social policies underlying the imposition of any funding standards in this area.

One might argue that the assets should always be maintained at a level adequate to provide all vested benefits. In other words, the assets should be at least equal to the present value of vested benefits accrued to date. Imposition of such a standard would greatly reduce the possiblility of future benefit loss.

Imposition of such a standard, however, would have other drastic social consequences. As a person becomes older, the cost of providing benefits to that person increases. The increase becomes very dramatic as the person approaches retirement. Consider a medium sized or large company with a significant number of employees at all ages. One could establish a plan which either provides or does not provide for benefits attributable to service prior to the adoption of the plan, which are called past service benefits. Consider a benefit formula of one percent of compensation per year of service and an employee hired at age 30 who is 60 years of age when the plan is established and is earning $20,000 per year. The employee's normal retirement age is 65. If the plan does not provide past service benefits, the plan will provide that individual with a monthly pension equal to $83.33 (one percent × five years × $20,000 × 1/12) or five percent of that individual's monthly pay. Such a pension is inadequate. If the individual were age 64, the monthly pension of $16.67 would be an insult. It would take many years before the plan would provide meaningful benefits to anyone, and the senior employees who were those most in need and most concerned about a pension at the time when the plan was established, would get the least. An alternative would be to provide a benefit for past service. The individual who was 60 years of age when the plan was established would get a pension upon working to age 65 of $583.33 (one percent × 35 years × $20,000 × 1/12) or 35 percent of pay. As of the date of establishment of the plan that individual's vested accrued benefit could be $500 per month (one percent × 30 years × $20,000 × 1/12). If the funding standards were designed to require the immediate funding of all vested accrued benefits, the employer would have to immediately contribute possibly $43,000 for that one individual. Clearly such a cost (more than twice the individual's annual salary) would be prohibitive. Such a standard would, therefore, tend to eliminate past service benefits. The answer to this problem is to permit past service benefits but to require funding over a longer period of time. However, it should be recognized that this answer results in plan assets initially being inadequate to provide all vested benefits. Even for a plan that has been in effect for some time and might have plan assets equal to the value of all vested benefits, a plan amendment increasing past service benefits will cause the value of vested benefits to increase immediately to become greater than plan assets while any increase in unfunded past service liabilities resulting from the amendment is merely required to be funded over the following 30 years. Further, as a plan continues in existence, actual plan experience may result in significant actuarial losses, meaning that the costs actually experienced by the plan were greater than the costs that were estimated such as what could result from severely adverse investment performance. However, if the actuarial assumptions are reasonable, such occurrences should be generally balanced out by experience gains over the long run.

Although an actuarial soundness standard is desirable from many perspectives, there are important contrary considerations. The enactment of minimum funding standards, rather than more stringent "actuarial soundness" standards, reflects all of these considerations. Under the standards that have been enacted, the Service cannot require that any plan become actuarially sound.

Another area in which this committee expressed concern is with respect to terminating plans where assets revert to the employer. Under the Internal Revenue Code assets may revert to the employer on termination of a pension plan after all liabilities of the plan (whether or not vested) have been satisfied. Because of this provision, a pension plan whose assets exceed the present value of accrued benefits may become a candidate for termination in order for the employer to obtain a reversion. This type of action, of course, would be more prevalent during periods of economic difficulties or of high interest rates.

This type of undesirable termination is clearly of concern to all of us. One may therefore ask why the law permits such reversions and why plan assets are permitted to accumulate to such an extent that termination to obtain reversion becomes an attractive option. To answer that question, one must consider a few important concepts.

Consider a new plan of a new employer providing a benefit of $10 per month per year of service. There is no past service in this plan. Further, assume that the employer contributed to the plan an amount precisely equal to the value of the $10 per month accruing each year. This method of funding is known as the unit credit method. For a single individual age 25, the contributions to be made each year would increase because each year the individual is nearer to retirement. The contributions in the later years may become so large that the employer's ability to maintain the plan may be jeopardized. To eliminate the higher costs in the later years, funding methods which level out the costs are used. As compared with the unit credit funding method, such level funding methods results in higher contributions in the early years and lower contributions in the later years. The assets under these level funding methods may accumulate to an amount exceeding the present value of accrued benefits.

An illustration of these points is presented in the Exhibit A, which has been distributed. I will pause briefly so that you may review that exhibit. Initially low but subsequently increasing costs of the constant $10 per month retirement benefit accruing each year are shown in Column (1). This pattern of costs contrasts with the level costs to fund the same total retirement benefit shown in Column (3). Because these level costs are initially greater than the costs of the benefit accruing, the assets accumulated under the level funding method exceed the value of the accrued benefits as can be seen by comparing Columns (2) and (4). The figures in Column (5) show that the amount of such excess continues to increase until the unit credit costs become greater than the sum of the level cost and the earnings on such excess. After that point in time, the amount of this excess continues to decrease until at retirement age the total assets accumulated under each method would be equal.

Additionally, some plans provide for benefits based on final average pay. Funding methods, to preclude sharply rising costs, permit current funding based on assumed final pay. If a plan terminates, however, the accrued benefits are measured on the pay to the date of termination. To summarize, funding methods permitting the accumulation of assets beyond the present value of accrued benefits are permitted in order to preclude large increases in cost.

The other question is even if assets are permitted to exceed the present value of accrued benefits, why are reversions permitted. Couldn't the law be designed to require the assets to be used to increase the participants' benefits?

If one considers a terminating plan, precluding reversions may seem quite desirable. However, many believe that such preclusion would seriously impact on the funding of plans. An employer may be willing to fund on a basis as opposed to a unit credit basis if the employer's real costs are not effected. The real, long-term costs of a pension plan are the benefits paid out. Differences in funding from year to year do not affect real costs; they merely affect the incidence of costs. If reversions were precluded, an employer's real costs would be increased because larger benefits than those promised would be paid in the event of termination. Many employers would therefore conclude that conservative funding may be too costly and they would fund on the unit credit method. Such funding may, over time, jeopardize the employer's ability to maintain the plan.

Thus it would seem that concern over reversions on termination may have to be balanced against concerns relating to adequate plan funding.

The fourth item in the letter of April 17, 1982, requested testimony regarding the Schedule B. An employer maintaining a defined benefit plan that is subject to ERISA's minimum funding standards is required to file a Schedule B for each plan year as an attachment to the Form 5500 Series Annual Return. The Schedule B Form contains actuarial information on the plan and must be signed by an enrolled actuary.

After annual returns are filed with respect to pension plans, the Service initially checks if a Schedule B is filed with respect to plans where the filing suggests that a Schedule B is required. The Service corresponds as needed based upon this initial review. Thereafter, certain data from the Schedule B are transcribed and retained. As part of our examination program, the Schedules B information is reviewed in light of selection criteria and some plans may be selected for examination. Some of these operations are automated and some are manual.

As mentioned earlier, actuarial assumptions are required to be reasonable in the aggregate. Even prior to ERISA, the Service had analyzed actuarial assumptions for reasonableness in light of plan experience although primarily for the purpose of not permitting deductions for plan contributions to be too large. With the Service now responsible for administering ERISA's minimum funding requirements, actuarial assumptions and plan experience are also reviewed for the purpose of not permitting required contributions to be too small. We are currently working to promote compliance with the requirement that acturial assumptions be reasonable in the aggregate.

That concludes the Service's prepared remarks, and we will be glad to try to answer any questions you may have.

EXHIBIT A

	Unit credit cost	Present value accrued benefit	Annual level cost	Accumulated assets	Potential reversion on termination (4) – (2)
	(1)	(2)	(3)	(4)	(5)
Age of individual					
25	$109	$109	$273	$273	$164
30	146	875	273	1.907	1,032
35	195	2.148	273	4,094	1,946
40	261	4.181	273	7,020	2.839
45	350	7,343	273	10.936	3.593
50	468	12.166	273	16.176	4,010
55	626	19.412	273	23.188	3,776
60	838	30.168	273	32.572	2.404

The above table assumes that all the actuarial assumptions are realized. This table was designed only to illustrate a point. It was not constructed in a manner to maximize the potential reversion.

The CHAIRMAN. Thank you very much, Mr. Winborne.

Let me start with Mr. Clayton. How long after knowledge of the Harper & Row case, before you investigated?

Mr. CLAYTON. I cannot give you a number of days or weeks, but shortly after it came to our attention and it is currently under investigation.

The CHAIRMAN. What was the result of your investigation?

Mr. CLAYTON. On Harper & Row, we are still conducting the investigation.

The CHAIRMAN. How long has it been since you had notice of that transaction?

Mr. Clayton. Several months at least. The investigation should be finished toward the end of this month.

The Chairman. How long will the investigation then have been in effect?

Mr. Clayton. At least 3 or 4 months. It has taken at least that long.

The Chairman. You were not able to conclude your investigation before the suits were started?

Mr. Clayton. No.

The Chairman. When did you investigate the A&P case?

Mr. Clayton. The A&P investigation, again, took a shorter period of time than Harper & Row has. The issues in the Harper & Row case are more complex than those in A&P. Again, it took us several months to complete the investigation, but we have completed the A&P investigation.

The Chairman. How long has that investigation been in effect?

Mr. Clayton. We basically finished our work on it some time ago. The period of time it took for the investigation was in the order of at least 3 or 4 months.

The Chairman. Somehow these other people got the idea that you all didn't intend to investigate either one of these transactions.

Mr. Clayton. As a matter of fact, A&P has been investigated and Harper & Row is still under investigation.

The Chairman. You haven't concluded one of the investigations?

Mr. Clayton. The Department of Labor has completed its portion of the A&P investigation.

The Chairman. Have you approved what took place?

Mr. Clayton. We haven't found any violation on our part. We have referred the file to the PBGC for followup.

The Chairman. What is the basis of your not finding any improprieties?

Mr. Clayton. The code specifically provides that a company can terminate its pension fund under certain circumstances.

The Chairman. That would give any corporate employer or other employer the right to terminate a pension program at any time it or he wishes to do so?

Mr. Clayton. Each case must be looked at on its own facts, but as a general rule, an employer has the right to terminate his pension plans.

The Chairman. Under all circumstances?

Mr. Clayton. No.

The Chairman. Then it is not an absolute right.

Mr. Clayton. That is what I meant. You have to look at the facts and circumstances of each case. The general rule is, we have a volunteer pension system, the employers can create a pension system when they wish, they are not compelled to, and under many circumstances they can terminate.

The Chairman. Assuming they can terminate the pensions system, but does that mean they can appropriate the pension funds?

Mr. Clayton. It depends on the facts and circumstances of a given case.

The Chairman. Depending on the facts and circumstances?

Mr. CLAYTON. Yes. Certainly, there are situations, particularly in a defined benefit plan, where an employer can terminate the plan and after they have made provisions for benefits as is required by the code, they can then take those excess assets.

The CHAIRMAN. You are basing your action the—that there was not an impropriety in the A&P case, upon the finding that there was enough money left in the fund after the company took several millions or hundreds of millions, to pay all the vested obligations as long as there was any possibility that the recipient might live, and pay any amount that might subsequently vest to any person working for that company at any time during that plan's effectiveness?

Mr. CLAYTON. Yes. It is my understanding they have to make provision for not only vested, but accrued benefits. Once they make that provision, then they are free to take the excess assets and use them as they wish.

The CHAIRMAN. You say only the vested?

Mr. CLAYTON. The vested and accrued.

The CHAIRMAN. What about all those other people, such as some fellow who is 64½, after he has been with the company long enough to vest by 65, but won't have 10 years until he gets to be 65, you are saying they can take that prospective benefit away from him, and there is no wrong in that.

Mr. CLAYTON. They can't take the prospective benefit away. As I understand it, they must provide for not only vested benefit, but accrued benefit.

The CHAIRMAN. Either vested or accrued. What do you mean by accrued?

Mr. CLAYTON. Benefits that under the schedule of benefits they are entitled to.

The CHAIRMAN. Well, he hasn't become entitled to any benefits until he retires.

Mr. CLAYTON. Perhaps a better term would be benefits that he has earned. Benefits that a particular party has earned. Maybe that is a better term.

The CHAIRMAN. You used that synonymously with vested.

Mr. CLAYTON. No, I don't.

The CHAIRMAN. What is the difference between accrued and vested?

Mr. CLAYTON. At a given time, let's say, I earn so many dollars per month for each year that I work for the company. Let's say I earn $50 a month for each year that I work for the company. After 3 years, I would have earned a pension benefit of $150.

That pension benefit may not have been vested, but I still would have earned it. As I understand the termination provisions, I am entitled to the $150 a month whether or not it is vested.

The CHAIRMAN. You mean in the A&P case that they left enough money after taking away the $200 million, they left enough money to take care of any possible potential benefits of everybody working for the company during the time that pension plan was in effect?

Mr. CLAYTON. With the exception that they have to provide for benefits first, before they can take any money from the plan. They have to make appropriate provision for the benefit.

The CHAIRMAN. Do you recall what my question was, Mr. Clayton?

Mr. CLAYTON. Yes. Your statement is mostly correct. There are circumstances, for example, where an employee might have worked for the company for such a short period of time that he may not have even earned a benefit.

He might be a temporary employee, he could be a part time or maybe he only worked for a short time.

The CHAIRMAN. Let's say the rule was you had to be 5 years with the company before you would be eligible to a pension. A fellow has been there 4 years, but he knows there is a pension system and that he will become eligible when he has been there 5 years.

You don't think he has any right?

Mr. CLAYTON. Under the plan, he may have an earned benefit——

The CHAIRMAN. I am not talking about under the plan. Suppose the plan doesn't give him any specific rights until he has been there 5 years. You say he has no rights? They can take all the money out of the pot and when he gets there after 5 years, there won't be any money?

Mr. COHEN. Under the ERISA minimum participation standards, a plan cannot exclude a person by virtue of age or service until the later of 25—or 1 year of service.

Thus, a plan could not satisfy the requirements and say a person may not enter the plan for 5 years. There are also provisions that once you enter the plan, this defined benefit plan, you have to accrue benefits.

Now, what ERISA does on these accrued benefits, just to clarify something, you have three things, you have accrued benefits, vested benefits and entitlements. For the accrued benefits, ERISA requires you accrue benefits by certain formulas.

Now, you accrue benefits right away, and you are accruing them throughout your participation in the plan. You may not vest in them. Vesting means where, when you leave at this point, if you have enough service you may have vesting and you determine——

The CHAIRMAN. What is the difference between vested and accrued?

Mr. COHEN. An accrued concept is like what you have earned.

The CHAIRMAN. Can you get it?

Mr. COHEN. No, not necessarily, you just accrue it.

The CHAIRMAN. You can't get it until it vests?

Mr. COHEN. That is correct.

The CHAIRMAN. Now, you say there was money left in this A&P plan to pay every man or woman every amount that could possibly accrue to them under the pension plan?

Mr. COHEN. That is right. Whether or not vested.

The CHAIRMAN. What?

Mr. COHEN. The money could not, under the law, revert back——

The CHAIRMAN. You mean you took the life expectancy of each one and managed how much he would be able to receive and you kept in the pot that much money to protect him?

Mr. COHEN. I cannot indicate on A&P specifically, because as Mr. Winborne testified, we have not gotten a determination letter request and anything that would be considered an examination could not be disclosed.

However, under the law, money cannot revert back until all liabilities, whether or not vested, have been satisfied. So in the case of an individual who has an accrued benefit—that is they have earned a certain benefit but they wouldn't get it unless they had a requisite amount of service—these benefits have to be paid off.

The CHAIRMAN. You are telling me that they kept enough in the pot so that they would have enough by the time it would vest in 10 years, which was the required time for vesting, it started, let's say, accruing at 3 years and they saved enough money so it could be there 10 years, so they would have enough money to vest and then he could stay on until he retired at 65 and be assured there was enough money there to take care of him?

Mr. COHEN. No, sir——

The CHAIRMAN. Does he have a right to stay on the job, unless they fire him or he quits or falls out for some reason? Isn't he entitled to an expectancy if he meets the conditions of the fund, of the program?

Mr. COHEN. What the law states is that you determine what is accrued as of the date of termination. Whether or not the person has satisfied——

The CHAIRMAN. So you are giving him an out. Any time they want to prevent accruals or prevent vesting, all they have to do is terminate the plan. Take the money and put it away. If that is the law, it ought not to be the law.

Mr. WINBORNE. Mr. Chairman, that is the present state of the law, I believe.

The CHAIRMAN. Mr. Winborne, I don't think you have the same responsibility that the Department of Labor or PBGC. You act where they want a certain tax benefit, and you determine whether or not they are entitled.

You don't go into the morality or the inequitableness of the conduct or whether they are cutting off anybody funds should be retained for.

Mr. WINBORNE. I think your statement is absolutely correct.

The CHAIRMAN. I put you in a little different category.

Mr. WINBORNE. I would like to make clear I think Mr. Cohen was simply trying to explain his understanding of the ERISA statute and the difference between vesting and accrued.

Anything he says should not be taken as a discussion of the A&P case, because we cannot discuss anything under examination.

The CHAIRMAN. If every employer in America chose to do what Harper & Row and A&P chose to do, I think I can imagine dire consequences for the pension systems of this country, a shaking of confidence on the part of people covered by pension plans and the public, in the responsibility of the system. In the good faith. The good faith in the sense that man assumes good faith in dealing with his fellow man, that he is not going to be bound by a Philadelphia lawyer's contract altogether, but by a code of fairness and equity and justice.

I think those principles are pertinent to this inquiry. If the law permits anybody to pull out of a pension system any time he wants to, maybe we better take another look at the law.

Thank you gentlemen very much. I appreciate your all coming.

The CHAIRMAN. The hearing stands adjourned.

[Whereupon, at 2:55 p.m., the select committee was adjourned.]

[The following material was subsequently received from Mr. Clayton in response to written questions by the Chairman:]

U.S. Department of Labor

Labor-Management Services Administration
Washington, D.C. 20216

Reply to the Attention of

SEP 16 1982

Honorable Claude Pepper
Chairman
Select Committee on Aging
U. S. House of Representatives
Washington, D. C. 20515

Dear Chairman:

This is in response to your request that we answer a series of questions related to your June 7, 1982 hearing on "Pension Funding Problems". Enclosed are our responses. We would be happy to provide any further information you may require.

Sincerely,

Jeffrey N. Clayton
Administrator
Pension and Welfare
Benefit Programs

Enclosure

Question

1. In your testimony before the Committee, you stated that section 408(c)(3) of ERISA enables a fiduciary with respect to a plan, in certain instances, to act as an officer of the company and not incur liability as a fiduciary in a decision to voluntarily terminate a pension plan. Does section 408(c)(3) specifically provide an exemption for the decision by an employer to terminate a plan and does the legislative history of this provision support this conclusion?

Response

Section 408(c)(3) does not provide specifically an exemption for the decision by an employer to terminate a plan. Nor does the legislative history address this matter. The legislative history of the section, however, does clearly indicate that Congress intended to allow an individual to serve both as a corporate official and a plan official. For example, on page 101 of the Senate Finance Committee Report (Report 93-383), it states:

> Recognizing current practice, the bill also does not prohibit a person from serving as an officer, employee, agent or other representative of a party in interest.

In addition, ERISA does not require any employer to start or maintain a plan. Such a decision is a business decision that the employer must be able to make for himself.

Question

2. With respect to question #1, would the opinion regarding that factual situation change if, through the employer's decision, the pension plan terminated and the employer realizes a substantial monetary benefit (the employer recovers "excess plan assets" from the trust)?

Response

Section 403(c)(1) of ERISA provides generally that "the assets of a plan shall never inure to the benefit of any employer and shall be held for the exclusive purposes of providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of administering the plan;" it also provides several specific exceptions to these requirements. One of these exceptions, section 4044(d) of ERISA, allows for the residual assets of a single-employer plan to be distributed to the employer under specific circumstances (all liabilities of the plan to participants and beneficiaries have been satisfied, the distribution does not contravene any provision of law, and the plan provides for such a distribution in these circumstances).

As pointed out in question 1, the law also does not require an employer to continue his plan. Thus, the mere fact that the employer terminated the plan and thereby obtained "excess plan assets" in accordance with relevant provisions of ERISA and the plan would not change his actions into a fiduciary violation.

Question

3. With respect to the factual situation posited in question #1, wherein the employer has realized a susbstantial monetary benefit through the receipt of excess plan assets, has the employer violated the exclusive benefit rule of section 404 of ERISA?

Response

The employer cannot violate section 404 of ERISA unless he was acting in his fiduciary capacity. As pointed out in the answers to questions #1 and #2, the decision by a corporate official to terminate a plan is a business decision. In addition, even if the decision was a fiduciary decision, as noted in the answer to question #2, section 403(c)(1) of ERISA specifically permits reversion of residual assets to an employer under certain conditions. In this regard, it should be noted that the provisions of section 404(a)(1) are, as stated in that section, "subject to sections 403(c) and (d), 4042, and 4044." Accordingly, it does not appear that such a reversion would constitute a "per-se" violation of the exclusive purpose rule of section 404(a)(1)(A).

Question

4. How does the Department construe the present status of federal law with respect to the application of the fiduciary rules of ERISA where trustees of a pension plan effect a transfer of assets from one plan of an employer to another plan of that same employer. Specifically, what is the present status of the fiduciary rules as enunciated under Eaves v. Penn, 587 F. 2d 453 (10th Cir. 1978) and Cutaiar v. Marshall, 590 F. 2d 523 (3rd Cir. 1979) and would the holding in these cases have specific application to the voluntary termination and transfer of plan assets in the Harper and Row situation?

Response

In Cutaiar, a pension fund and a welfare fund had the same trustees but somewhat different participants and beneficiaries. The court found that these common trustees in loaning funds from one plan to another violated the ERISA prohibition against fudiciaries acting on behalf of parties whose interests are adverse to the plan. Eaves had a different fact pattern from Cutaiar. In Eaves, the trustee of the plan, who was also an officer and director of the company, used plan assets to finance the sale of the company. Both the solely in the interest and prudence standards of section 404 of ERISA were violated.

To the extent that Cutaiar and Eaves provide guidance on the meaning of ERISA's fiduciary provisions they are relevant for the Harper and Row situation. However, Harper and Row is a unique fact situation that is still under investigation. It would be premature to state the applicability of any prior case until that investigation and our analysis are complete.

Question

5. Is the Department concerned, from a standpoint of public policy, that the continuity and reasonable assurance to employees that coverage under a pension plan of an employer may be disrupted by voluntary terminations such as those evidenced by the A and P Stores and Harper and Row Publishers plan terminations? Would the Department recommend any specific legislation to treat such voluntary terminations?

Response

The Department is concerned by any plan termination that results in employees no longer receiving pension plan coverage from their employers. We would like to see as many employers as possible provide pension coverage for their workers. We, however, recognize that the private pension system is a voluntary one and, in such a system, employers are free to terminate plans, consistent with their legal obligations, as well as establish them. We also want to encourage funding of plans. Thus, the concept of totally prohibiting under any circumstances the return to employers of excess plan assets would be troublesome.

The Administration has recommended legislation strengthening single-employer termination insurance provisions of the law and increasing premiums. Such legislation would put the termination insurance program on a sounder basis, and protect participants and beneficiaries.

Question

6. Some employers, such as Harper and Row and Hallmark, have installed employee stock purchase and profit sharing arrangements, wherein the majority of the assets of the plan consists of employer stock or securities. Employee stock ownership plans (ESOPs) have a specific statutory exemption to invest in employer stock or securities which is not the case with the other aforementioned plan arrangements. Is the Department aware that a number of employers have installed these arrangements which appear to violate section 404 and 406 of ERISA, and has the Department provided any guidance or taken any enforcement action to discourage the installation or maintenance of these types of arrangements?

Response

Section 407(b)(1) specifically allows all eligible individual account plans (which by definition include employee stock purchase and profit sharing plans) to invest primarily in qualifying employer securities. Section 408(e), in part, provides an exemption from the prohibitions of section 406 for the acquisition or sale by a plan of qualifying employer securities if certain conditions are met. However, in making these investments, fiduciaries for these plans are still subject to the requirements of sections 404 and 406, except for the provisions requiring diversification under section 404. The Department has brought several suits against employee stock ownership plans (ESOPs) in which fiduciaries are being charged with imprudent actions such as having the plan pay more than adequate consideration for qualifying employer securities or with conflicts of interest where the fiduciary personally benefited from a stock purchase or sale. For your information, we have attached a copy of the Department's response to a draft of the GAO's June 20, 1980 report on ESOPs (HRD 80-88). The response highlights the Department's efforts to provide special scrutiny to ESOP's, and was included as Appendix I to the final GAO report.

The Department has also had success in litigation involving abusive dealings in employer securities by other types of pension plans, as shown by the recent decision of the U. S. Court of Appeals for the Second Circuit in Donovan v. Bierwirth, et al., 680 F.2d 263 (2nd Cir., 1982).

We would welcome any further information the Committee may have on specific violations of the fiduciary provisions.

Question

7. With respect to question #6, wouldn't these employee stock purchase plans and other plan arrangements violate the "fair return" principle enunciated by the Internal Revenue Service under Revenue Rulings 69-65, 69-421 and 69-494? I believe that the Department has received certain correspondence from Mr. Robert Manley of the Commonwealth Group concerning this matter.

Response

Section 404 of ERISA provides, in part, that a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and for the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable administrative expenses and with the "care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."

The Department has set forth in regulations (29 CFR 2550.404a-1, see attached) its views on compliance with the prudence standard. Under these regulations, among other things, when making an investment decision, the fiduciary must give "appropriate consideration to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role the investment or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties."

The regulation goes on to indicate that appropriate consideration should include the composition of the portfolio, the liquidity and current return of the portfolio relative to the cash flow requirements, and the projected return of the portfolio relative to the funding objectives.

In the preamble to the final regulation (44 FR 37225) the Department stated its belief that the prudence rule "does not require that every plan investment produce current income under all circumstances."

Whether any particular course of investment action involving employee stock purchase plans and other plan arrangements violate these title I standards is dependent on the facts and circumstances of the particular case.

Question

8. The Department in an early interpretative bulletin indicated that certain professionals acting in their professional capacity with respect to the plan, are not "fiduciaries" with respect to the plan. Does this position absolve such professionals, for example, an enrolled actuary who unreasonably adopts an overly optimistic interest rate assumption for funding purposes with respect to the plan, from responsibility as a fiduciary of that plan? Does the exemption from fiduciary status for professional conduct extend to obvious errors or omissions by such professionals in their conduct with respect to the plan?

Response

Interpretive Bulletin 75-5, D-1 (29 CFR 2509.75-5) while noting that actuaries, among others, are not ordinarily fiduciaries when performing their usual professional functions, states that they may be considered fiduciaries "if the factual situation in a particular case falls within one of the categories" described in the definition of a fiduciary in section 3(21) of ERISA. Thus, no "exemption from fiduciary status" is provided for such persons, and to the extent they exercise discretionary authority or discretionary control respecting the management or disposition of the plan's assets, renders investments advice for a fee, direct or indirect, with respect to the assets of the plan, or has any authority or responsibility to do so, or has any discretionary authority or responsibility in the administration of the plan, they would be considered plan fiduciaries.

Even in the case where an actuary is not a fiduciary because of the specific fact situation, the actuary is still subject to the professional standards of performance established by the Joint Board for the Enrollment of Actuaries. The Board's professional standards, 29 CFR 901.20, require the enrolled actuary to:

> exercise due care, skill, prudence and diligence to ensure that:
>
> (1) The actuarial assumptions are reasonable in the aggregate and the actuarial cost method and the

actuarial method of valuation of assets are appropriate.

(2) The calculations are accurately carried out, and

(3) The report, any recommendations to the plan administrator and any supplemental advice or explanation relative to the report reflect the results of the calculations.

Violation of this standard is grounds for suspension or termination.
Moreover, the Department has been successful in establishing that under ERISA a non-fiduciary who knowingly participates, directly or indirectly, in a breach of fiduciary duty would be liable to the plan at least to the extent that the non-fiduciary has profited from the breach. See McDougall v. Donovan, 539 F.Supp. 596 (N.D. Ill., 1982).

U. S. Department of Labor

Inspector General
Washington, D.C. 20210

MAR 1 8 1980

Mr. Gregory J. Ahart
Director
Human Resources Division
U. S. General Accounting Office
Washington, D. C. 20548

Dear Mr. Ahart:

This is in reply to your letter to Ray Marshall, Secretary of the United States Department of Labor, requesting comments on the draft GAO report entitled, "Employee Stock Ownership Plans: Who benefits most in closely held companies--employers or employees?"

The Department's responses are enclosed.

The Department appreciates the opportunity to comment on this report.

Sincerely,

Marjorie Fine Knowles
kmb
MARJORIE FINE KNOWLES
Inspector General

Enclosures

U. S. Department of Labor's Response To
The Draft General Accounting Office Report
Entitled, "Employee Stock Ownership Plans:
Who benefits most in closely held companies--
employers or employees?"

Recommendation: The Secretary of Labor should develop and promulgate through regulations and implementing procedures, more specific criteria and guidelines for valuing stock of closely-held companies.

Response: The Department concurs.

Comments: The Department of Labor has previously provided guidance on the valuation of stock for which there is no generally recognized market. In a speech before the ESOP Council of America on May 7, 1979, Ian D. Lanoff, Administrator, Pension and Welfare Benefit Programs, reiterated the Department's position that a fiduciary should make a good faith determination with respect to the fair market value of stock by utilizing recognized methods of valuing stock in closely-held corporations. Mr. Lanoff further noted that the factors outlined in Revenue Ruling 59-60 should assist the plan fiduciary in making valuation determinations.

Although the myriad of factual situations precludes the development of a precise method of determining adequate consideration in the case of ESOP purchases of employer securities, the Department remains committed to the development of standards for plan fiduciaries making valuation determinations. The Department hopes to develop more specific guidelines for valuing the stock in closely-held companies as our experience in the ESOP area grows.

The Department wishes to note that it is currently in the process of considering whether to formally adopt the guidelines contained in Revenue Ruling 59-60 for the valuation of qualifying employer securities for which there is no generally recognized market under section 3(18) of ERISA.

U. S. Department of Labor's Response To
The Draft General Accounting Office Report
Entitled, "Employee Stock Ownership Plans:
Who benefits most in closely held companies--
employers or employees?"

Recommendation: That the Secretary of Labor promulgate regulations to require plan provisions for redeeming, at fair market value, all company stock distributed by an ESOP.

Response: The Department does not concur.

Comments: Regulations issued by the Department under the definition of an ESOP contained in section 407(d)(6) of ERISA require that employer stock acquired by an ESOP with the proceeds of an exempt loan must be subject to a put option if it is not publicly traded at the time of distribution. It is the Department's view that ERISA does not confer similar authority to require put options under all circumstances involving the distribution of closely-held employer stock by an individual account plan designated an ESOP. Congress, in enacting the Revenue Act of 1978, amended the Internal Revenue Code to require that participants receiving a distribution of employer stock from a TRASOP or a leveraged ESOP must generally be given a put option in the case of an employer whose stock is not publicly traded at the time of distribution. It would appear that further legislative action would be necessary in order to impose additional plan provisions pertaining to the redemption of all closely-held employer stock distributed from an ESOP.

U. S. Department of Labor's Response To
The Draft General Accounting Office Report
Entitled, "Employee Stock Ownership Plans:
Who benefits most in closely held companies--
employers or employees?"

Recommendation: To carry out the Congress' intent to guard against potential abuse of ESOPs by parties-in-interest, we recommend that the Secretaries of Labor and Treasury develop and implement a program for providing special scrutiny of ESOP transactions.

Response: The Department does not concur.

Comments: The Department is of the view that its past programs have provided the special scrutiny mandated by Congress and that present programs continue to assure that such scrutiny will be provided in the future. Within the constraints of its limited resources, the Department's activities in this area, since the passage of ERISA on September 2, 1974, have included the following:

- The Department has opened over 150 cases on ESOPs, 42 of which are presently pending.
- Of these cases, four have resulted in litigation. Since, in total, the Department has brought approximately 40 lawsuits alleging violations of ERISA, the number of lawsuits involving ESOPs represents approximately 10% of all suits filed. One additional lawsuit is contemplated in the near future and others are under active consideration by the Office of the Solicitor.
- The Kansas City Region of LMSA, the Region containing the most LMSA area offices, instituted a special targeting effort concentrating solely on ESOPs. ESOPs are the only type of employee benefit plan which has ever been singled out for such special targeting. As a result of this project, 27 ESOPs were investigated in depth.

- Investigative and auditing guidelines designed specifically for examining ESOPs have been developed. These guidelines have been distributed throughout the program for use in investigations of ESOPs.

With regard to ESOP investigations, the main issue usually confronting DOL auditors is the proper valuation of employer securities. This issue, therefore, has been the primary focus of all Departmental activity with regard to such investigations. As stated by Ian Lanoff, Administrator of the Pension and Welfare Benefit Programs, in a speech on May 7, 1979 to the ESOP Council of America:

> We place great importance on the process of determining the value of securities in the ESOP context because the purchase or sale of employer securities by the Plan may directly benefit those persons responsible for the investment decision and because adequate consideration is more difficult to determine because the stock may not be publicly traded or may not have a generally recognized market.
>
> A problem common to several ESOPs which has come to the attention of the Department is the failure of plan fiduciaries to take sufficient steps to determine the value of the securities prior to the purchase.

This emphasis has also been reflected in the activities of the ERISA Advisory Council of the Department of Labor. The investment and fiduciary responsibility work group of that Council, recognizing the importance of ESOPs, undertook a detailed study of the Department's activities in this area. In its report to the full Advisory Council, on November 7, 1979, the committee recommended that: "The Department be commended for its enforcement focus in the ESOP context on 'adequate consideration' for, and proper valuation of, employer securities...."

The Department's emphasis in this area is continuing. With regard to staff training, internally, LMSA is developing a two week long course in investments one of the main focuses of which is valuation of employer securities. Externally, the Department has recently had three of its supervisory personnel attend a pilot valuation training program developed by the IRS. The Department contemplates that additional employees will attend future sessions of this course as it is offered.

As indicated by the Kansas City Pilot Program, it is possible to successfully target ESOPs for investigation. However, to increase the Department's ability to select plans for such investigations, changes have been made in the Form 5500 series for the year 1979. For the first time, this form includes specific questions relating to ESOPs. Question 19(c) is as follows:

> (c) Is this a plan with Employee Stock Ownership Plan (ESOP) features?
>
> (i) If "yes," was a current appraisal of the value of the stock made immediately prior to the contribution of the stock or the purchase of the stock by the trust?
>
> (ii) If (i) is "yes," was the appraisal made by an unrelated third party?
>
> (iii) If (ii) is "no," was the appraisal made in accordance with provisions of a Revenue Ruling 59-60?

It is anticipated, when responses to the 1979 Form 5500 series are received that this item (as well as other items) will be computer scrutinized as part of the Department's ongoing program of targeting plans for future investigations.

In the past, it has been through such analysis of reports filed with the Department that most investigaitons have been instituted. For example, of the 20 investigations listed in our memorandum to you of July 11, 1979, only five were generated by a participant complaint. Two were referred to us by other Governmental agencies and the other 13 were generated internally based on reviews of reports filed by the plans.

In conclusion, it is the Department's view that it has, within the constraints imposed by its available resources, fully complied with its congressional mandate to provide special scrutiny to ESOPs. In the past, this special scrutiny has taken the form of a major special project devoted solely to the investigation of ESOPs, the opening of cases on over 150 such plans, and the filing of four lawsuits. In the future, this special scrutiny will continue to exist in the form of additional lawsuits, increased training of LMSA personnel with regard to stock valuation, and special emphasis on targeting potential abuses through new reporting requirements in the 1979 Form 5500 series.

BEST AVAIL

Regulations

Reg. § 2550.404a-1 was filed with the Federal Register on June 25, 1979. Reg. § 2550.404b-1 was adopted by FR Doc. 77-29187, filed with the Federal Register on September 30, 1977, and published in the Federal Register of October 4, 1977 (42 FR 54122).

[¶ 14,742]

§ 2550.404a-1 Investment Duties—(a) *In general.* Section 404(a)(1)(B) of the Employee Retirement Income Security Act of 1974 (the Act) provides, in part, that a fiduciary shall discharge his duties with respect to a plan with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.

(b) *Investment Duties.* (1) With regard to an investment or investment course of action taken by a fiduciary of an employee benefit plan pursuant to his investment duties, the requirements of section 404(a)(1)(B) of the Act set forth in subsection (a) of this section are satisfied if the fiduciary (A) has given appropriate consideration to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role the investment or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties; and (B) has acted accordingly.

(2) For purposes of paragraph (1) of this subsection, "appropriate consideration" shall include, but is not necessarily limited to, (A) a determination by the fiduciary that the particular investment or investment course of action is reasonably designed, as part of the portfolio (or, where applicable, that portion of the plan portfolio with respect to which the fiduciary has investment duties), to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment or investment course of action, and (B) consideration of the following factors as they relate to such portion of the portfolio:

(i) the composition of the portfolio with regard to diversification;

(ii) the liquidity and current return of the portfolio relative to the anticipated cash flow requirement of the plan, and

(iii) the projected return of the portfolio relative to the funding objectives of the plan.

(3) An investment manager appointed, pursuant to the provisions of section 402(c)(3) of the Act, to manage all or part of the assets of a plan, may, for purposes of compliance with the provisions of paragraphs (1) and (2) of this subsection, rely on, and act upon the basis of information pertaining to the plan provided by or at the direction of the appointing fiduciary, if—

(A) such information is provided for the stated purpose of assisting the manager in the performance of his investment duties, and

(B) the manager does not know and has no reason to know that the information is incorrect.

(c) *Definitions.* For purposes of this section:

(1) The term "investment duties" means any duties imposed upon, or assumed or undertaken by, a person in connection with the investment of plan assets which make or will make such person a fiduciary of an employee benefit plan or which are performed by such person as a fiduciary of an employee benefit plan as defined in section 3(21)(A)(i) or (ii) of the Act.

(2) The term "investment course of action" means any series or program of investments or actions related to a fiduciary's performance of his investment duties.

(3) The term "plan" means an employee benefit plan to which Title I of the Act applies.

[¶ 14,745]

§ 2550.404b-1 Maintenance of the indicia of ownership of plan assets outside the jurisdiction of the district courts of the United States.—(a) No fiduciary may maintain the indicia of ownership of any assets of a plan outside the jurisdiction of the district courts of the United States, unless: [Amended by 64 FR 1266, originally scheduled to be effective February 6, 1981. However, the effective date was delayed under the President's regulation freeze until March 30, 1981 (46 FR 10465).]

(1) Such assets are (i) Securities issued by a person, as defined in section 3(9) of the Employee Retirement Income Security Act of 1974 (Act) (other than an individual), which is not organized under the laws of the United States or a State and does not have its principal place of business within the United States, (ii) securities issued by a government other than the government of the United States or of a State, or any political subdivision, agency or instrumentality of such a government, (iii) securities issued by a person, as defined in section 3(9) of the Act (other than an individual), the principal trading market for which securities is outside the jurisdiction of the district courts of the United States, or (iv) currency issued by a government other than the government of the United States if such currency is maintained outside the jurisdiction of the district courts of the United States solely as an incident to the purchase, sale or maintenance of securities described in paragraph (a)(1) of this section; and

(2) (i) Such assets are under the management and control of a fiduciary which is a corporation or partnership organized under the laws of the United States or a State, which fiduciary has its principal place of business within the United States and which is—

(A) A bank as defined in section 202 (a)(2) of the Investment Advisers Act of 1940 that has, as of the last day of its most recent fiscal year, equity capital in excess of $1,000,000;

(B) An insurance company which is qualified under the laws of more than one State to manage, acquire, or dispose of any asset of a plan, which company has, as of the last day of its most recent fiscal year, net worth in excess of $1,000,000 and which is subject to supervision and examination by the State authority having supervision over insurance companies; or

(C) An investment adviser registered under the Investment Advisers Act of 1940 that has, as of the last day of its most recent fiscal year, total client assets under its management and control in excess [of] $50,000,000 and either (*1*) Shareholders' or partners' equity in excess of $750,000 or (*2*) all of its obligations and liabilities assumed or guaranteed by a person described in paragraph (a)(2)(i)(A), (B), or (C)(*1*) or (a)(2)(ii)(A)(*2*) of this section; or

(ii) Such indicia of ownership are either

(A) In the physical possession of, or, as a result of normal business operations, are in transit to the physical possession of, a person which is organized under the laws of the United States or a State, which person has its principal place of business in the United States and which is—.

(*1*) A bank as defined in section 202 (a)(2) of the Investment Advisers Act of 1940 that has, as of the last day of its most recent fiscal year, equity capital in excess of $1,000,000;

(*2*) A broker or dealer registered under the Securities Exchange Act of 1934 that

APPENDIXES

Appendix I

BRIEFING ON PROBLEMS IN PENSION FUNDING AND GUARANTEES

INTRODUCTION

A pension plan in its simplest terms is a legal promise by the employer to pay a periodic benefit (usually for the life of the retiree) to employees who meet the requirements set forth in the plan. Funding of a pension plan is a method of assuring that there are adequate resources or assets available to pay benefits as employees retire.

There are basically two types of plans which are utilized by employers. Under a defined contribution or money purchase plan, the employer contributes a fixed amount or contribution, and the employee's benefit varies depending upon such factors as the amount of contributions made, investment earnings on plan assets, and the employee's age, sex, and normal retirement age under the plan (usually age 65). Under a defined benefit plan, the employer sets a definite benefit which will be paid at retirement, and the employer must contribute necessary amounts to assure that these benefits will be paid at retirement. Under a defined benefit plan, the employee is promised a specific benefit after meeting the service requirements of the plan, and the employees benefits are not affected by any investment gain or loss on the plan's assets.

Many of the problems associated with the funding of retirement benefits are related to the nature, operation and regulation of a defined benefit plan under the Employee Retirement Income Secuirty Act of 1974 (ERISA). This involves not only the organic provisions of this law but the regulation and enforcement of the federal agencies, the Department of Labor, the Internal Revenue Service and the Pension Benefit Guaranty Corporation, which administer the provisions of ERISA and the Internal Revenue Code which apply to employee pension benefit plans.

The problems upon which this hearing will be focused are: (1) whether there is an underfunding of plans, particularly in certain industries and certain tyes of employers; (2) the voluntary terminations of certain large defined benefit pension plans, and (3) the financial solvency of the Pension Benefit Guaranty Corporation and its plan termination insurance program, particularly after the bankruptcy of Braniff Airlines.

FUNDING

There are four purposes for funding, the current payment or contribution of money to a pension plan by an employer.

The first is to protect and secure the benefit rights of plan participants (employees) and beneficiaries. Money which is contributed and placed in trust is accumulated and invested and set aside specifically to pay the benefits of retired employees of the employer. If there were no funds set aside to pay benefits, the plan participants would be completely dependent upon the employers future willingness and ability to honor his promise to pay benefits. Advance funding therefore provides a segregated fund irrevocably committed to the payment of benefits to plan participants and beneficiaries.

The minimum funding requirements of the Employee Retirement Income Security Act of 1974 (ERISA) [1] mandate that an employer contribute minimum amounts annually to a defined benefit pension plan which includes the normal costs of the plan plus amortization of past service liabilities, experience losses and other factors which influence the cost of operating the plan.

In single employer plans these costs must be generally funded or amortized over a 30 year period.[2] Thus, the employer under a defined benefit pension plan is obligated to advance fund the benefits that ultimately will be paid to plan participants and beneficiaries. Generally, the minimum funding requirements do not apply to profit-sharing or stock bonus plans or certain plans which are funded through insurance contracts.

A second purpose is the protection of the plan termination insurance program administered by the Pension Benefit Guaranty Corporation (PBGC). Essentially, PBGC insures that plan participants and beneficiaries under a terminated plan will receive a certain level of benefit insurance if the plan and the employer are unable to meet their benefit obligations under the plan. Under this program, plan participants presently are insured up to approximately $1,380 per month or the average monthly compensation of the participant during the five consecutive years of highest salary. If a defined benefit plan terminates and its assets are less than the actuarial present value of the insured benefits, the PBGC is contrained to meet the deficiency (subject to possible claims against the assets of the employer for an amount not greater than 30% of the employer's net worth).

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[1] Section 301 et. al of Part 1, Title I and section 421 of the Internal Revenue Code of 1954 (the Code)

[2] Initial past service liabilities and past service liabilities arising under plan amendments are to be amortized over no more than 30 years; 40 years for the unfunded past service liabilities; and experience gains and losses are to be amortized over not more than 15 years. With respect to multiemployer plans, past service liabilites generally may be amortized over no more than 40 years, and experience losses over no more than 20 years.

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Clearly, it is impracticable to have plan termination insurance if there is no requirement or obligation on an employer to make advance payments to fund the costs and pay benefits under the plan. Therefore, advance minimum funding of a defined benefit pension plan provides this protection.

As will be demonstrated later, to the extent plans are not adequately or minimally funded, this underfunding increases the exposure of the PBGC to increased liability for insurance benefits.

The third purpose served by funding is the enforcement of fiscal responsibility by an employer. By this, it is meant that the employer is forced to recognize the costs associated with maintaining the plan and must plan to meet these costs with certain specified payments made over a number of years.

A fourth purpose of funding, and one not particularly associated with this hearing is reducing the employer's outlay for maintaining the plan. If an employer maintained the plan without funding on a current disbursement approach, or in other words out of the general account of the employer, the employer might pay $54,000 to provide a $300 a month benefit for an employee who retires at age 65 and lives 15 years thereafter. However, if payments were accumulated through a series of level annual installments extending from age 30 to 65 discounted for interest at 5%, but not for mortality, the outlay for the same level of benefit will cost only $13,212 or about one-fourth of the cost of providing the benefit through the current disbursement method.

IS THERE AN UNDERFUNDING PROBLEM?

Depending on the various indexes which are used, it would appear that many private pension plans are well-funded. However, this conclusion may be skewed depending upon the particular industry or employer that one identifies. There appears to be particular problems in the tire, rubber and steel industries where some employers evidence large unfunded liabilities relative to assets.

Also, the particular index which is used to measure the assets and liabilities of these pension plans also influences the figures regarding the unfunded liability of these plans. Under the annual Business Week magazine pension liability survey released on September 14, 1981, the survey of the country's 100 largest corporations, ranked by sales, based on the Standard & Poor's Compustat Services, Inc., showed an overfunding of basic pension obligations by almost $11 billion. The previous year's survey of the same corporations showed an underfunding of approximately $22 billion.

This dramatic change is largely the result of a change in the method by which pension liabilities are measured. Changes in the accounting rules regarding pension plans in the past year, specifically opinion numbers 35 and 36 issued by the Financial Accounting Standard Board (FASB) in their measurement formula, disregard the higher future earnings on which pensions would generally be based. Depending on the type of funding formula, under the FASB rules, no calculation for salary increaes is required which would markedly affect a final projection of unfunded liabilities.

These recent FASB opinions were evolved out of considerable controversy regarding the appropriate measurement formula and are only interim standards until a final standard is adopted. Previously, there was little uniformity in the disclosure of pension liabilities and data generally was sketchy at best.

The most common pension liability measure was the amount of unfunded vested benefits, the difference between the computed value of legally binding pension promises and the assets currently set aside in a pension plan to meet those liabilities. This calculation varied from company to company, depending upon the acturarial assumptions that were chosen by the actuary for that plan and which therefore afforded little comparability from one company to another.

The FASB accounting opinions also result in greater information concerning pension plans. Rather than simply list unfunded liabilities, companies now must list total benefits they have promised to current and former employees, the portion of these benefits that have been vested, and the current market value of pension assets. Plans must also disclose the rate of return factor used to calculate the value of the benefits and explain any significant changes in funding, plan earnings, or actuarial assumptions made during the year. However, the computation under these FASB rules only take into consideration pay and service to that date and not future salary increases for current employees, and this restriction has been strenuously criticized.

For example, at DuPont Company, the current annual report sets out vested benefits of $3.9 billion and pension plan assets of $5.5 billion, indicating a funding surplus of $1.6 billion. But the company notes in its report that "Most actuarial cost methods also provide for the calculation of such values on a basis which recognizes projected future pay increases." It concludes: "For plans which define benefits in relation to pay in the final years of employment, such projected pay increases can have a material impact." In DuPont's case, inclusion of the pay increase factor would increase its current projected obligation by $1.7 billion and put it into a slightly underfunded position.

Similarly, under the new FASB opinions, the General Electric Company shows some $140 million more in its pension fund than the value of its total pension obligation. Based on the acturarial method used by the company for funding however, G.E. indicates that it has an unfunded position of $964 million.

The new FASB formula also discloses data on the rate of return assumptions used by actuaries to value pension benefits. Figures from 1980 indicate a considerable variation among some of the larger corporations. The average rate of return for all 100 companies under the Business Week survey was 7.5%. Companies such as General Dynamics, General Electric, General Telephone and Electronics, and Georgia Pacific used a 6% return, while such companies as Alcoa, Bethlehem Steel and LTV used a 10% interest rate assumption. Firestone utilized the highest rate of return of 10.7% while IBM used only 4.75% rate in its calculations.

Certain companies have particularly improved their financial picture by assuming higher interest rate assumptions. Almost two-thirds of the $333 million in profits reported by General Motors Corp. for 1981 was the result of changes in actuarial assumptions for the company's pension fund. Specifically, GM raised its interest assumption for its pension funds to 7% from 6%, and increased its salary assumptions, on an average, from 3% to 5%. The net effect of these changes reduced pension contributions enough to add about 70 cents per share to the company's earnings for the year. With approximately 300 million shares outstanding at year end, the interest assumption contributed about $210 million or 63% of the company's 1981 profit.

Similarly, American Airlines, Eastern Airlines, Chrysler and Ford raised their interest rate assumptions. Specifically, in the case of American Airlines, boosting their interest assumption saved the company $14.8 million because of lower pension contributions. Thus, a number of companies who were strapped for cash have looked to

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increased actuarial or return assumptions for relief through lowered contributions to their pension funds and improved earnings.

BEA Associates, Inc. in its 1981 BEA Pension Survey, indicates that there has been a general trend toward removing the unfunded liabilities of pension plans.

They note that unfunded pension liabilities began to improve in 1978 with the trend accelerating in 1979 and 1980. However, BEA notes that under the new FASB Statement No. 36, companies are allowed to use a different interest rate assumption for disclosure purposes than for funding purposes. For example, Western Union uses a 6% rate in determining its pension contribution, but for its 1980 annual report it chose to use an 8.1 discount rate because that is the equivalent of the rate used by the Pension Benefit Guaranty Corporation in calculating annuity values. BEA further notes that "For the group as a whole, the median growth of vested benefits for 1980 was 10.1%. However, for the nine companies that used a higher interest assumption than they had the previous year, vested benefits actually declined 0.6%, while they rose 15.4% for the nine companies that used the same rate in both years." BEA goes on to note that those companies that raised their interest assumptions and reduced the present value of their vested benefits were under more pressure on the asset side than those that opted to use the same assumption they had in the previous year. BEA concludes its survey by noting that pension cost and liability figures continued to improve in 1980 through the robust performance of the stock market, however, just as important for some companies were the provisions of FASB No. 36 that only recognize accrued benefits and allowed the use of higher interest rate assumptions for disclosure purposes.

STATUTORY MINIMUM FUNDING STANDARDS

ERISA requires that for the purposes of setting up a funding plan for a pension plan, an enrolled actuary must calculate on the basis of actuarial assumptions and actuarial cost methods which are reasonable and which in combination offer the actuary the best estimate of anticipated experience under the plan. Moreover, the plan's assets are to be valued as permitted under the Department of Treasury's regulations.

As noted earlier, under ERISA minimum funding requirements, the minimum amount that an employer is to contribute annually to a defined benefit pension plan includes the normal costs of the plan plus amortization of past service liabilities, experience losses and gains and other factors salient to maintaining the plan. Under the funding rules, each covered plan is to maintain an account called a "funding standard account." This account is to aid the Government in determining whether the plan is meeting the minimum funding requirements. The account is used to assure that a contributing employer who has funded more than the minimum required is credited for that excess and for the interest earned on that excess. Similarly, where the employer has contributed too little, the account is to assist in enforcing the minimum funding standard and to assure that the employer is charged with interest on the amount of underfunding.

Each year the funding standard account is to be charged with the liabilites which must be paid to meet the minimum funding standard. Also, each year the funding standard account is to be credited with contributions under the plan and any other decrease in liabilities (such as amortized experience gains). If the plan meets the minimum funding requirements as of the end of each year, the funding standard account will show a zero balance (or a positive balance if the employer has contributed more than the minimum required). If the minimum contributions have not been made, the funding standard account will show a deficiency (called an "accumulated funding deficiency"). If

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there is an accumulated funding deficiency, an excise tax is to be imposed on the employer who is responsible for making contributions to the plan. Also, the responsible employer may be subject to civil action in the courts because of his failure to meet the minimum funding standards.

If an employer would otherwise incur substantial business hardship, and if application of the minimum funding requirements would be adverse to plan participants in the aggregate, the Internal Revenue Service may waive the requirement of current payment on part or all of a year's contributions of normal costs, as well as amounts needed to amortize past service liabilities and experience losses. The amount waived (plus interest) is to be amortized not less rapidly than ratably (including interest) over 15 years, and no more than 5 waivers may be granted for any 15 consecutive years.

Attached at the end of paper (APPENDIX 1) are responses from the Internal Revenue Service concerning its administration of the minimum funding standards outlined above. Note that the figures are incomplete or are inconclusive because of certain reporting anomolies noted by the Service.

However, the figures attached do suggest the following:

1. That there have recently been a growing number of defined benefit pension plans with accumulated funding deficiencies, although lower than the 1976 and 1977 years. Figures are not complete for 1980 reporting year.

2. There appears to be an increasing amount of deficiency in aggregate dollar terms although this cannot be determined conclusively because of anomolies in the data.

3. That the number of funding deficiency waivers applications have increased generally. The Service has also granted a higher number of such applications.

The increase in grant of the number of waivers directly increases the exposure of the PBGC under it's program of plan benefit insurance. The question that may be posed is what is the Service doing to coordinate this burden with the PBGC? Furthermore, what can be done with respect to section 412 of the Code to control or otherwise restrict the granting of such waivers which may not be justified in every instance but are constrained to be granted under section 412 of the Code?

A further question may be raised as to whether the financial data on minimum funding provided through the Schedule B, Actuarial Information, provides the Service with any comparative norms on how plans are faring in their funding.

Also, with respect to the recent increases in interest rate assumptions adopted by many employers, is the Service monitoring these increases, and do they believe that they are reasonably justified for certain companies, particuluary those who want to improve their share of earnings which improve theri overall financial appearance.

VOLUNTARY TERMINATIONS OF OVERFUNDED PENSION PLANS

In the past nine months three major corporations have made or attempted to make use of assets in pension funds for the benefit of the corporation. Inspite of the fact that Sec. 406 of ERISA prohibits return of the assets to the corporation, it is likely that the corporation, can receive any surplus over vested liabilites under the pension fund.

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Thus, the following events have occured...

A. HARPER AND ROW

On November 6, 1981, Harper and Row Publishers, Inc. terminated its pension plan and amended its profits-sharing plan and used the "excess" money contained in the fund to purchase over one million shares of its stock that was owned by the Minneapolis Star and Tribune.

The retirement plans together provided more than half of the purchase price of the 1,017,630 shares which the company purchased for $20 per share.

To succeed the formerly terminated pension plan, Harper and Row set up an employee stock purchase plan which will hold most of the purchased shares. The stock plan and the profit-sharing plan will receive the shares at market prices rather than the $20 paid by the company.

As a result of these changes, the company will not make any further pension or profit-sharing contributions for the next five years.

According to the Pension Benefit Guaranty Corporation, the defined benefit pension plan had $16.9 million in assets and $7.3 million in liabilities. The balance of $9.6 million was used for the purchase of the stock.

The profit-sharing plan also used $1.5 million of its $3.5 million in assets to buy the stock.

Under the terms of the plan, as noted in the proxy statement concerning the purchase of shares, the "excess" of assets in the plan will revert to the corporation.

In February, 1981 the Minneapolis Star and Tribune decided to sell its block of Harper and Row stock which amounted to 33% of all outstanding shares. Since the shares constituted such a large block of stock, the Harper and Row Board of Directors decided to review various options pertaining to the stock. The board reviewed the current and future prospects of Harper and Row concluded that the stock was undervalued making a sale or merger of the company "inopportune."

In it's proxy statement, Harper and Row expressed concern that the company's editorial independence might be compromised and was also concerned that "the continued availability for purchase of a large block of the Corporation's stock could create uncertainty detrimental to the Corporation." The proxy statement goes on to indicate that "the Board also recognized that if the Corporation were able to acquire the Minneapolis Tribune stock on satisfactory terms, it would have the opportunity to utilize such in connection with a restructuring of its employee benefit plans..."

To date, one shareholder has filed a class action stock derivative suit on behalf of shareholders. Some former Harper and Row executives are concerned and disagree with the actions that the Corporation has taken.

At contention and in part the basis of the stock derivative suit is the fact that the stock was purchased at $20 per share while the market price is well below that. Specifically, at the time that the agreement between the Minneapolis Star and Tribune and the company was executed on Septemeber 15, 1981, the quote on the stock was $10-5/8 bid, $10-7/8 asked.

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Former chairman of the board of directors, and chief executive officer, Raymond C. Harwood, who own 17,000 shares, has indicated that the shares owned by the Minneapolis Star and Tribune represented a control position that could be voted as a block. He has contended that the management of Harper and Row sought to avoid having the stock fall into hands that "may not be so attractive to the present management." In other words, as contended in the stock derivative suit, the intent of the buyback was to ensure the stock did not fall into unfriendly hands so as to "ensure the entrenchment of the present management."

Another factor which is cited as being adverse to plan participants after the termination of their defined benefit plan is their present coverage under a new employee stock purchase plan and the remaining profit-sharing plan. As compared to the vested and therefore protected benefits under their former defined benefit pension plan, Harper and Row plan participants are now part owner in company stock whose worth will fluctuate with its market value. The company contends that employees will be happier and more productive as part owners through the stock purchase plan.

Critics of the transaction also point out that the company has been placed in a more questionable financial picture by the purchase of shares since the market value of the company's stock continued to deteriorate.

With respect to the Harper and Ros situation, it is of paricular concern that although employees will not lose any vested bendits, they have lost the protection of their defined benefit plan and received instead stock of a lesser and insecured value. Moreover, there is some indication that the company's financial condition may have been jeopardized by paying more than the market price for the stock.

B. A & P STORES

The second example is the Great Atlantic and Pacific Tea Company (A&P) which has announced its intention to terminate its $550 million defined benefit pension plan and will seek to replace it with a defined contribution arrangement.

The plan is overfunded on a termination basis and will allow the company to take back between $200 to $250 million which it indicates will be used to restructure the company.

The present value of the accumulated vested plan benefits was about $179 million while the present value of the unvested benefits was about $5.9 million. These figures were calculated using the Pension Benefit Guaranty Corporation interest assumption of 9%. Because annuities can be purchased with 15% investment returns presently, the actual present value of the vested liablities is much lower, even when all employees are granted full vesting. When the company purchases annuities with $353 million of the plan's assets, a surplus of approximately $200 to $250 million will result for the company.

Apparently in response to an earlier takeover attempt, A & P had included a plan provision which provided that any surplus upon termination would revert to the employees, not the employer. In January, 1979, Mr. Erivan Haub, a West German national through the Tenglemann Group Inc., now personally owns more than half of the A & P stock and effectively controls the company. Through years 1979 to 1981, no additional contributions were made to the plan, however, the surplus in assets grew to in excess of $200 million. On July 16, 1981, the board of directors amended the termination provision of the plan to provide that any surplus upon termination reverted to the employer. Three months later, on Octoboer 16, 1981, the board announced it's intention to terminate the plan.

The announced intention of A & P management to terminate its plan is presently the basis of litigation by Mr. William Walsh, a former executive of A & P who has brought a class action suit to enjoin the termination of the plan and to maintain the excess plan assets for reversion to the plan participants. The suit is presently in negotiations for settlement.

C. GRUMMAN

The third incident is separate and distinct factually from the voluntary terminations described above but similar in terms of concern. This involves the recent suit by the Department of Labor against the trustees of the $650 million Grumman Corporation pension plan, charging them with "imprudent" action in using pension assets to block a takeover of Grumman by LTV Corp.

As stipulated in court papers, the trustees used pension assets to buy $40 million worth of Grumman shares on October 12 and 13, 1981 for around $38 a share. By October 16 the government said the shares had slipped $10 million in value.

The Department claimed that the trustees knew that the stock was likely to decline markedly in value when it appeared the takeover bid would fail. The federal Eastern District Court of New York found that the trustees had committed a violation of section 404, which provides that a fiduciary (trustee) of a plan shall discharge his duties with respect to a plan solely in the interest of plan participants and benficiaries, through an "imprudent" action of purchasing Grumman stock. This decision has just been affirmed on appeal. The District Court order provides for the removal of the three trustees and injunction on any further administration of the Grumman plan by these trustees. A question which may be raised in this context is whether the Grumman trustees could have committee these actions which would otherwise be violation of ERISA, if they had simply terminated the plan, if it were overfunded, and use any excess assets to purchase Grumman stock to stave off the takeover bid.

The voluntary terminations of the Harper and Row and A & P plans is of significance from several standpoints.

First, it may be important to determine whether present high interest rates, the declining financinal condition of certain employers, the increased number of attempted takeover and merger bids and the increased costs of maintaining a defined benefit pension plan are having an effect on employers which will lead them to terminate their overfunded pension plan to obtain any reversion in excess plan assets?

It is important to note at this juncture that under ERISA there is no requirement that an employer establish a plan, nor is an employer prevented from voluntarily terminating a plan. If the assets under the plan are not sufficient to meet the vested liability of participants, certain clearences must be obtained from IRS and the PBGC. The Code does contain provisions which relate to the intention of the employer to maintain a permanent arrangement of benefits, but this qualification requirement does not obviate in any way, the ability of the employer to voluntarily terminate his plan.

A second concern which might be addressed under this section is the appliation of present law under ERISA and the Code with repect to these plan terminations.

Specifically, with respect to the termination f an overfunded plan where the excess assets revert to the employer and inure to his employer's interest, do such actions result in a violation of the fiduciary repsonsiblity provisions under sections 404(a), 406(a) or 406(b). These sections under Title I of ERISA are as follows:

Fiduciary Duties:

Section 404. (a) (1) Subject to sections 403 (c) and (d), 4042 and 4044, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and —

(A) for the exclusive purpose of:
(i) providing benefits to participants and their beneficiaries; and
(ii) defraying reasonable expenses of administering the plan;

(B) with the care, skill, prudence, and diligence under circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with the like aims;

(C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and

(D) in accordance with the documents and instruments governing the plan insofar as much documents and instruments are consistent with the provisions of this title.

(2) In the case of an eligible individual account plan (as defined in section 407(d)(3), the diversification requirement of paragraph (1) (C) and the prudence requirement (only to the extent that it requires diversification) of paragraph (1) (B) is not validated by acquisition or holding of qualifying employer real property or qualifying employer securities (as defined in section 407(d) (4) and (5).

Prohibited Transactions

Section 406 (a) Except as provided in section 408:

(1) A fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect —

(A) sale or exchange,or leasing, or any property between the plan and a party of interest;

(B) lending of maoney or other extension of credit between the lan and a party in interest;

(C) furnishing of goods, services, or facilities between the plan and a party in interest;

(D) transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan; or

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(E) acquisition, on behalf of the plan, of any employer security or employer real property in violation of section 407(a).

(2) No fiduciary who has authority or discretion to control or manage the assets of a plan shall permit the plan o hold any employer security or employer real propoerty if he knows or should know that holding such security or real property violates section 407 (a).

(b) A fiduciary with repect to a plan shall not —

(1) deal with the assets of the plan in his own inteest or for his own account,

(2) in his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) wholse interests are adverse to the interests of the plan or the interests of its participants or beneficiaries, or

(3) receive any consideration for his own personal account from any party dealing with such plan in connectin with a transaction involving the assets of the plan.

With respect to these provisions, a question may arise as to whether a decision by the plan trustees who terminate the plan to specifically benefit the employer may, under certain factual situations, constitute action that is imprudent in that the fiduciary or trustee is not acting soley in the interest of the plan's participants and beneficiaries and for the exclusive purpose of providing benefits to plan participants and beneficiaries.

Similarily, a concern arises as to whether a fiduciary (trustee) with respect to a plan, shall not cause the plan to engage in a transaction which directly transfers to the employer assets of the plan. Moreover, a 406(b) violation might result if the trustees deals with the assets of the plan in his own interest or acts in a capacity involving the plan on behalf of a party which is adverse to the interests of the plan and its participants and beneficiaries.

Although these are concerns or scenerios under which fiduciary liability might result, it is unclear whether or not the fiduciary obligation extends to the decision by the employer and the trustees to terminate the plan.

With respect to particular requirements under the Code, section 411(d)(3) provides that full vesting of accrued benefits, to the extent funded, is required upon the termination or partial termination of the plan. With respect to the termination of the A & P plan, there is some concern that as declining employer who has discharged a numbe of employees over the past several years, A & P plan may have incurred a partial termination under which such discharged employeres should be fully vested under Code section 411(d)(3).

If it is determined that the present provisions of ERISA and the Code are not appropriate in regulating the voluntary termination of plans, then some possible legislative considerations might be as follows:

A. An amendment to ERISA and the Code that any excess plan assets that may be available upon the termination of the plan only revert to the plan participants and beneficiaries and not to the employer; and,

B. That any excess plan assets be used as a means to fund cost of living increases to retirees. The National Retired Teachers Association/American Association of Retired Persons (NRTA/AARP), takes the position that when investment returns make it affordable, a retiree must be able to argue to plan sponsors that some portion of their plans liberalizations should be devoted to cost-of-living protection for retirees.

One of the concerns that is represented by the termination of the A & P and Harper and Row pension plans is whether terminations like these will accelerate and in one sense thereafter affect the continuity of coverage of employees under employee pension benefit plans. Although the number of pension plans with significant overfunding is probably statistically few in number, the extent to which employers may wish to voluntarily liquidate these plans is as yet unclear.

Another aspect of the termination of these defined benefit plans is the successor plan which has been installed by the employer as a replacement.

Profit-sharing, employee stock purchase and Employee Stock Ownership Plans (ESOP) have been utilized by a number of employers as a successor retirement program after the termination of their previously established defined benefit or defined contribution pension plan.

One criticism levied against these arrangements as replacements for, particulary defined benefit pension plans, is that they do not provide the same level, type or the security represented under a defined arrangement.

For example, under a defined benefit arrangement the employee is promised a sum certain when he reaches retirement age with the employer. The employee does not participate in any experience losses or gains under the plan, is entitled to a vested nonforfeitable benefit under the plan, and generally would under most plan formulations, receive a larger and guaranteed benefit for the remainder of his/her life than would typically be expected under these other arrangements.

Another problem associated with these arrangements is the large concentration of employer securities, property or stock which are often used to fund these arrangements.

Certain types of plans, ESOPs, have specific exemptions from certain fiduciary prohibitions under ERISA which permit these plans to maintain a concentration of employer stock within the plan. A definition of an ESOP is a qualified stock bonus plan or a combiniation qualified stock bonus plan and defined contribution (money purchase) plan designed to invest primarily in employer securities. Regulations of the IRS, in turn, define a stock bonus plan as a plan established and maintained by an employer to provide benefits similar to those of a profit-sharing plan, except the contributions by the employer are necessarily dependent upon profits and the benefits are distributable in the stock of the employer company. The plan deisgn aspects of an ESOP closely resemble those of a typical deferred profit sharing plan. Participation and vesting provisions must meet the requirements of the Code and, while the contribution formula may be based on profits, it generally requires a contribution that is a specified percentage of compensation.

As noted earlier, ESOPs are specifically exempted from the requirement of the exclusive benefit rule under section 404 under ERISA becuse of the specific formulation of this type of plan.

This is not the case with respect to the application of these requirements to investments in employer stock by qualified profit-sharing plans, and stock bonus plans.

Under Revenue Rulings 69-65, 69-421 and 69-494, the Service has indidcated that the "fair return" requirement is not applicable to stock bonus plans because of the obligatory requirement of such plans to invest in employer stock. ESOPs are, by definition, stock bonus plans and therefore are exempt under the "fair return" exemption for the practical implementation of ESOPs.

As noted in the Committee Report accompanying ERISA concerning ESOPs: "Because of such problems (...party in interest transactions...) the conferees intend that all aspects of these transactions will be subject to special scrutiny by the Department of Labor and the Internal Revenue Service to ensure that they are primarily for the benefit of plan particpants and beneficiaries." ESOPs (stock bonus plans) require that participants be given the right to demand distributions in stock, thereby fulfilling the ownerships cycle.

However, it is apparent that there are some practicioners who are marketing or offering advice that a profit-sharing plan can be utilized in a similar fashion. Specifically, it is suggest that by using a profit-sharing plan, the company would, at once, be relieved of the need to allow a participant to demand or receive his distribution in stock. Further, some practitioners suggest that leverage can be accomplished by having the company obtain a loan and shelter the payments by contributions of employer stock to the profit-sharing plan.

Such an arrangement with respect to a profit-sharing plan should not be exempt from the fair return prerequisite of the exclusive benefit rule.

Additional attention should be focused by the Department of Labor and the Internal Revenue Service on the operation of such profit-sharing arrangements. Moreover, these agencies should issue clarifying and definitive opinions concerning the application of the "fair return" requirement even where the plan document provides for acquisiton of employer stock. Without such clarification the true ownership purposes envisioned through ESOPs may well be emasculated by these proferred profit-sharing arrangements.

Moreover, such an arrangement has been employed to purchase a block of Harper and Row Stock under their newly instituted employee stock purchase plan. Such an arrangement, which if violative of the fair return requirement, represents a serious possibiity of erosion of benefit protection for participants covered under this and similar types of arrangements.

PLAN TERMINATION INSURANCE

Over a number of years and most notably with the bankruptcy of the Studebaker Corporation, a number of pension plans have terminated resulting in the loss of benefits to many workers who were covered under these plans. ERISA, to ameliorate this situation established a plan termination insurance program to provie insurance benefits through the establishment of the nonprofit Pension Benefit Guaranty Corporation (PBGC). The essential mission of the PBGC is to assure timely and uninterrupted payment of pension benefits to participants and beneficiaries of a plan which has terminated and has insufficient assets to meet its pension obligation.

The PBGC administers four "revolving funds" that provide insurance benefits under both single and mulitemployer defined benefit pension plans. Two of the funds are applicable to single-employer plans, one fund is used to assure the payment of basic pension benefits while the other is used for nonbasic benefits, if any are guaranteed by the corporation. The same arrangement applies to the two funds established to protect participants in multiemployer plans.

The PBGC has powers which enable it to intervene in the operation of retirement plans in the private sector should a major risk such as a funding deficiency occur.

Under PBGC rules, a voluntary plan termination occurs whenever all benefit accruals have ceased and the employer permanently has discontinued all contributions to the plan. Or the plan may be considered terminated whenever the employer permanently has discontinued contributions to the plan.

The merger, consolidation, or reorganization of a firm sponsoring a pension plan does not result in the termination of the plan if the successor organization assumes responsibility for the plan, unless the PBGC assumes that the seccessor is not economically strong enough to assume this burden and seeks to involuntarily terminate the plan.

With respect to involuntary plan terminations, the PBGC may start proceedings to terminate a plan if it finds that (a) the plan does not comply with the minimum funding standards of the Code; (b) the plan's unable to pay benefits when due; (c) wihtin the preceding 24 months, and for a reason other than death, a distribution of $10,000 or more has been made to a participant who is the substantial owner of the sponsoring firm and that following the distribution there are unfunded liabilities; (d) the eventual loss to the PBGC for the plan may be expected to increase unreasonably if the plan is not terminated. It is within PBGC's discretion as to whether to seek involuntary termination under any of these instances.

The plan administrator of any covered pension plan is required to report to the PBGC certain events that may indicate a possible termination of a pension plan. These reportable events include: (a) a loss of qualified status under the Code; (b) a plan amendment that decreases the benefits of paricipants or discontinues or reduces the accrual of future benefits; (c) a decrease in the number of active participants to 80% of the number at the beginning of the plan year, or 75% of the number at the beginning of the previous plan year; (d) an IRS determination that a complete or partial plan termination for tax purposes has occurred; (e) a failure to meet the minimum funding standards and certain other requirements such as plant closings or cessation of benefit accruals which may indicate to the PBGC a need to terminate the plan.

Title IV of ERISA imposes a limit on the amount of basic benefits insured by the PBGC. The amount is adjusted annually to reflect changes in Social Security. The original limit was $750 per month, but for plans terminated in 1980 the upward movement of national wages has raised the limit for this year up to $1,380 per month.

Title IV of ERISA created a contingent liability on employers who sponsor defined benefit pension plans to the extent of the lesser of the excess of the present value of the insured benefits over the market value of plan assets as of the date of plan termination, or 30% of the employer's net worth. The contingent liability applies only to insured benefits to the extent the value of those benefits exceeds plan asset value and does not apply to asset deficiencies for the funding of benefits in excess of insured benefits. In determining the net worth of the employer it is up to the PBGC to determine the basis which best reflects the current status of the employer's operations and prospects.

The 30% net worth liabilty applies with respect to single employer plans.

Under the Multiemployer Pension Plan Amendments Act of 1980 an employer withdrawing from a multiemployer plan must continue to fund a share of the unfunded benefit obligations in the plan when it withdraws. Withdrawal liability insures that employers who remain in the plan are not burdened with funding liabilities that should have been funded by the withdrawn employe. Withdrawal liability is also necessary to prevent employers fro abandoning a lan and shifting their unfunded liabilities onto the PBGC. Withdrawal liabilitiesof an employer is also not limited by its net worth.

It is this aspect of the bill and how it applies retroactively to certain withdrawn or withdrawing employers that has created a storm of criticism and 78 lawsuits which challenge the constitutionality of these provisions. A recent court decision, the Peick case, decided in a federal district court in Illinois, has upheld the consitutionality of the law.

FINANCIAL CONDITION OF THE PBGC

The PBGC covers approximately 33 million workers under its insurance coverage. The financing or premium which support the PBGC however, may not be adequate to protect the program from fiscal insolvency.

Presently, the PBGC is running a deficit of apprixmately $190 million on a termination basis. That is, if PBGC had to meet all its liabilities at one time instead of over a period of years, it would fall short by that amount. However, given the operation of the PBGC, it is maintaining a sufficient reservoir of money that it will continue to be able to meet its benefit payments to retirees. Last fiscal year, the PBGC collected $86.7 million in premiums and paid $61.1 million in benefits.

Yet the fact remains that PBGC does not have enough assets to cover its known future obligations to 71,000 workers and retirees in the 659 terminated plans which it currently administers. Some recent statistics indicate that pension plan terminations rose last year, [illegible] an end to four years of decline.

The problems which confront the PBGC are several.

Some very large single employers are in financial trouble, among them International Harvester, Chrysler and Eastern Airlines. Braniff has filed for bankruptcy within the past two weeks. The failure of the White Motor Corp. has helped push the deficit in PBGC's single-employer insurance fund to the $190 million mark for fiscal year 1981, up from $94.6 million in 1980.

Two or three more large pension plan terminations could overwhelm the PBGC's resources and generate strong employer resistance to pay higher premiums to meet the increased unfunded liability of the program.

Some companies are seeking ways of terminating underfunded pension plans and passing that liability onto the PBGC. Under this mechanism, the company is able to pass on its former liability to all other contributing employers in the insurance program.

The insurance premium which is charged to single employers who are covered under the program is $2.60 annually per worker. Presently, PBGC is approaching the Congress for a premium increase to $6.00 per worker. The deficit of the PBGC for 1981 is projected to be $147 million, and $247 million by 1985. The premium increase to $6.00 contemplated the reduction of this deficit over a five year period. However, the termination of the Braniff plan could affect premiums by adding an additional 67¢ to $1.00 to the premium request. Moreover some projections calculate that the failure of just two large companies, Chrysler Corporation and International Harvester Co. could require a $20 premium to cover their $2 billion in unfunded liabilities.

Braniff, depending on the calculations which are used, presumably represents an unfunded liability of between $60 to $115 million of unfunded liabilities which will have to be assumed by the PBGC. Under PBGC's calculations, the unfunded liability represented by Braniff is between $60 to $70 million. However, estimates prepared by Alicia H. Munnell, vice president of the Federal Reserve Bank of Boston, finds a potential liability of $115.6 million by using different interest rate assumptions.

Presently, the PBGC is as mandated under the Multiemployer Amendments (MPPAA) examining certain alternative premium structures to the flat rate premium presently in place. One system which is receiving some preliminary examinaiton is an experience rated premium system which would charge higher premiums for those employers who hold higher unfunded liabilities under their plan. One of the criticisms levied against the present flat rate structure is that an employer who adequately funds his plan and does not present a potential termination threat to the PBGC, must pay the same premium rate and thus subsidize employers whose plans are underfunded. A criticism levied against the experience rated premium system it that it would demand higher premiums from precisely those employers who are least financially capable of absorbing these higher premiums.

One of the important issues arising in this area is the financial condition of the PBGC now and in the immediate future and what steps must be taken to assure adequate benefit protection for plan participants and beneficiaries.

In addition, under a bill introduced by Representative John Erlenborn, H.R. 4330, and sponsored in the Senate by Senator Ron Nickles (S. 1541). Would revise the single employer termination provisions under Title IV of ERISA. These single employer revisions have generally been endorsed by the Administration.

Under this bill, the 30% net worth restriction on an employer's liability during termination would be removed and the employer would be required to continue to amortize the plan's unfunded liabilities. It would also impose contingent liability to PBGC for a specified period of years on employers, who transfer pension plans as well as on controlled groups whose affiliates are transferred.

These revisions would seem to be appropriate however, there are two issues which hae become the subject of some controversy.

One area of concern is how stringent the rules should be that would impose contingent liability in the case of transfers. Clearly, such restrictions should be adequate to protect the insurance system from abuse but, some employers and employer organizations are concerned that the proposed restrictions would inhibit valid business transfers.

A second issue is whether PBGC's employer liability claim, unlimited with respect to the employer's assets rather than the 30% net worth limit presently provided under Title IV, should have general creditor status or should be subordinated to the claims of all other creditors. The former would be more protective of PBGC's contributing employers but some employer groups have contended that it would make credit more difficult to obtain, particularly for firms with large unfunded liabilities.

SUMMARY

FUNDING

The advance funding of employee pension benefit plans, as required under the Employee Retirement Income Security Act of 1974 (ERISA) is designed to assure that there are adequate monies reserved by the employer to pay promised retirement benefits under the plan. To the extent that sufficient funds are not reserved, a condition of underfunding the pension plan, there will not be enough money to pay promised benefits to workers.

The importance of funding is obviously central to the effective operation of the private plan retirement system. Deficiencies like those apparently contemplated under Social Security could occur in our private system unless the funding process is carefully monitored.

The function and monitoring of pension plans is split among several professions and federal agencies. Enrolled actuaries develop a plan formula for funding a plan. Qualified independent public accountants review the financial solvency of the plan. The Internal Revenue Service and the Pension Benefit Guaranty Corporation monitor the minimum funding /qualification requirements and the financial solvency respectively, of these pension plans. The Department of Labor review whether the plan meets a number of ERISA requirements including, whether the plan is prudently managed and meets its other fiduciary duties.

An examination of the existing literature suggests that the majority of private pension plans are adequately funded, although a universal of approximately 1/4 of these plans may evidence some degree of underfunding. More importantly however, some plans may be adoping overly optimistic interest rate assumtions for their pension plans. This has the effect of lowering the employer's contribution to the plan and improving the earnings profile of the employer. In some instances, it is precisely those employers in the poorest financial condition that are adopting the highest interest rate assumptions. If these assumptions are not borne out by investment experience. Also, some of the older industries such as the tire and rubber and the steel industry are also experiencing problems of under funded pension plans.

VOLUNTARY TERMINATION

Within the past year, Harper and Row Publishers has terminated and the A & P Stores are attempting to terminate their defined benefit pension plan. Also, the Grumman Corporation, in an attempt to fend-off a takeover bid, utilized large sums of plan assets to purchase large blocks of employer stock in contravention of the ERISA prohibited transaction rules.

These plan terminations raise some very serious questions regarding the nature and quality of the promise to provide retirement benefits to workers under these plans. It should be noted that all vested employees would lose no benefits.

The actions taken by these employers specifically in one instance, raise questions as to the propriety, if not the legality, of the actions taken by these employers to convert excess plan assets for their own use.

An examination of whether present fiduciary or tax rules apply to these terminations is appropriate. Moreover, some consideration of whether legislative amendments to treat these situations may be appropriate. For example, laws which would reversion of excess plan assets to be used to provide cost of living adjustments might serve to thwart the desire of terminating overfunded pension plans to obtain cash.

PLAN TERMINATION INSURANCE

The mission of the Pension Benefit Guaranty Corporation (PBGC) is to provide insurance or benefits to workes whose plans are unable to pay promised benefits.

There have been an increasing number of defined benefit pension plan terminations within the last year.

With the recent bankruptcy of Braniff Airlines, serious questions are now being raised concerning the present nd future financial solvency fo the PBGC.

Presently, PBGC is approaching the Congress for an increase in its single employer per worker annual premium which is paid by the employer from $2.6 per worker to $6.00. However, these premium increases did not contemplate the bankruptcy of Braniff.

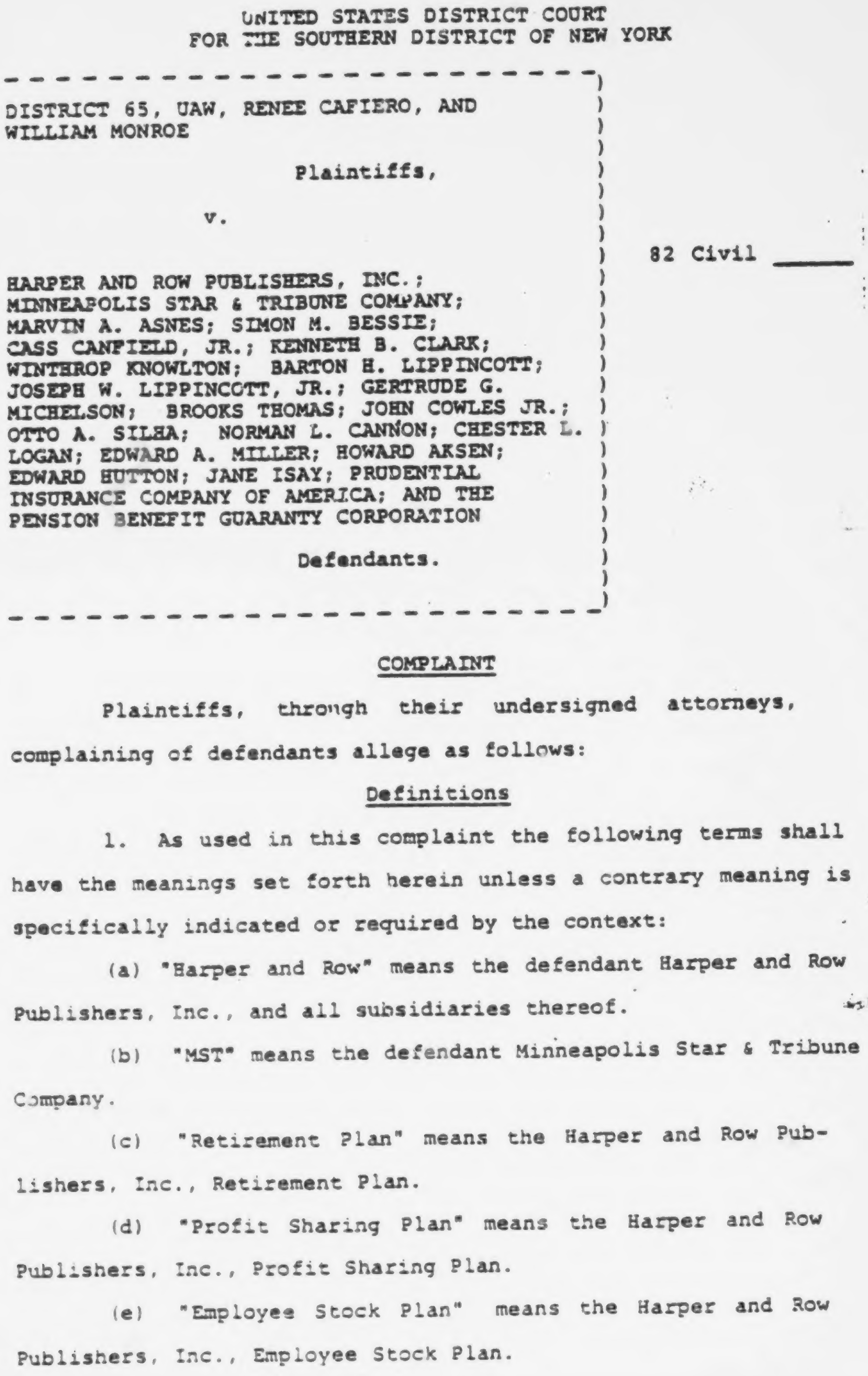
Whether additional premium increases and other financing arrangements will be necessary are open to further consideration by the Congress.

* * * * *

Brief #1

APPENDIX II

Submitted for the record by Regina Little



UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

DISTRICT 65, UAW, RENEE CAFIERO, AND
WILLIAM MONROE

Plaintiffs,

v.

HARPER AND ROW PUBLISHERS, INC.;
MINNEAPOLIS STAR & TRIBUNE COMPANY;
MARVIN A. ASNES; SIMON M. BESSIE;
CASS CANFIELD, JR.; KENNETH B. CLARK;
WINTHROP KNOWLTON; BARTON H. LIPPINCOTT;
JOSEPH W. LIPPINCOTT, JR.; GERTRUDE G.
MICHELSON; BROOKS THOMAS; JOHN COWLES JR.;
OTTO A. SILHA; NORMAN L. CANNON; CHESTER L.
LOGAN; EDWARD A. MILLER; HOWARD AKSEN;
EDWARD HUTTON; JANE ISAY; PRUDENTIAL
INSURANCE COMPANY OF AMERICA; AND THE
PENSION BENEFIT GUARANTY CORPORATION

Defendants.

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COMPLAINT

Plaintiffs, through their undersigned attorneys, complaining of defendants allege as follows:

Definitions

1. As used in this complaint the following terms shall have the meanings set forth herein unless a contrary meaning is specifically indicated or required by the context:

(a) "Harper and Row" means the defendant Harper and Row Publishers, Inc., and all subsidiaries thereof.

(b) "MST" means the defendant Minneapolis Star & Tribune Company.

(c) "Retirement Plan" means the Harper and Row Publishers, Inc., Retirement Plan.

(d) "Profit Sharing Plan" means the Harper and Row Publishers, Inc., Profit Sharing Plan.

(e) "Employee Stock Plan" means the Harper and Row Publishers, Inc., Employee Stock Plan.

(f) "ERISA" means the Employee Retirement Security Act of 1974, 29 U.S.C. § 1001 et seq.

(g) "Securities Act" means the Securities Act of 1933, 15 U.S.C. § 77(a) et seq.

(h) "Exchange Act" means the Securities Exchange Act of 1934, 29 U.S.C. § 78(a) et seq.

(i) "Stock Purchase Agreement" means the Stock Purchase Agreement, dated September 15, 1981, between Harper and Row and MST.

(j) "MST Stock" means the 1,017,630 shares of Harper and Row common stock owned by MST prior to sale of such stock to Harper and Row pursuant to the Stock Purchase Agreement.

(k) "MST defendants" means defendants MST, John Cowles, Jr. and Otto A. Silha.

(l) "Harper and Row defendants" means defendants Harper and Row, Marvin A. Asnes, Simon M. Bessie, Cass Canfield, Jr., Kenneth B. Clark, Winthrop Knowlton, Barton H. Lippincott, Joseph W. Lippincott, Jr., Gertrude G. Michelson, Brooks Thomas, Norman L. Cannon, Chester L. Logan, Edward A. Miller, Howard Aksen, Edward Hutton and Jane Isay.

(m) "Prudential" means defendant The Prudential Insurance Company of America.

(n) "PBGC" means defendant Pension Benefit Guaranty Corporation.

Parties

2. Plaintiff District 65, UAW, is a labor union which serves as the collective bargaining representative of approximately 280 employees of Harper and Row. All of such employees are participants and beneficiaries of the Retirement Plan and the Employee Stock Plan, and approximately one-third of such employees are participants and beneficiaries of the Profit Sharing

Plan. District 65, UAW, brings this action as the representative of all of its members who are participants or beneficiaries of the Retirement Plan, the Profit Sharing Plan or the Employee Stock Plan. District 65 brings this action on behalf of the Retirement Plan, the Profit Sharing Plan and the Employee Stock Plan, and all of the participants and beneficiaries thereof.

3. Plaintiffs Renee Cafiero and William Monroe are employees of Harper and Row and participants in the Retirement Plan, the Profit Sharing Plan and the Employee Stock Plan. They bring this action on behalf of each of such Plans, and all of the participants and beneficiaries thereof.

4. Defendant Harper and Row is a Delaware Corporation with its principal office and place of business at 10 East 53rd Street, New York, N.Y. 10022.

5. Defendant MST is a Delaware Corporation with its principal office at IDS Tower, Minneapolis, Minnesota, 55402. Prior to December, 1981 MST owned 1,017,630 shares of the common stock of Harper and Row, said shares constituting approximately 33 1/3% of the outstanding common stock of Harper and Row and, while owned by MST, were sufficient to permit MST to exercise effective control of Harper and Row.

6. Defendant Marvin A. Asnes is and at all times relevant to this action was a Director of Harper and Row.

7. Defendant Simon M. Bessie is and at all times relevant to this action was a Director of Harper and Row.

8. Defendant Cass Canfield, Jr. is and at all times relevant to this action was a Director of Harper and Row, and Editor of its Trade Department.

9. Defendant Kenneth B. Clark is and at all times relevant to this action was a Director of Harper and Row.

10. Defendant Winthrop Knowlton is and at all times relevant to this action was Chairman of the Board of Directors of Harper and Row, and a Director of MST.

11. Defendant Barton H. Lippincott is and at all times relevant to this action was a Director of Harper and Row.

12. Defendant Joseph W. Lippincott Jr. is and at all times relevant to this action was a Director of Harper and Row.

13. Defendant Gertrude G. Michelson is and at all times relevant to this action was a Director of Harper and Row.

14. Defendant Brooks Thomas is and at all times relevant to this action was a Director of Harper and Row, as well as President and Chief Executive Officer of Harper and Row.

15. Defendant John Cowles, Jr. was a Director of Harper and Row between February 1, 1981 and July 28, 1981. During such time he was also President of MST.

16. Defendant Otto A. Silha was a Director of Harper and Row between February 1, 1981 and July 28, 1981. During such time he was Chairman of the Board of MST.

17. Defendant Norman L. Cannon is and at all times relevant to this action was a Vice-President and Treasurer of Harper and Row, and a Member of the Retirement Plan Committee which was responsible for administering the Retirement Plan, and a member of the Profit Sharing Plan Committee which is responsible for administering the Profit Sharing Plan.

18. Defendants Chester L. Logan and Edward A. Miller are and at all times relevant to this action were Members of the Retirement Plan Committee which was responsible for administering the Retirement Plan.

19. Defendants Howard Asken, Edward Hutton and Jane Isay are and at all times relevant to this action were members of the Profit Sharing Plan Committee which is responsible for administering the Profit Sharing Plan.

20. Defendant The Prudential Insurance Company of America is a New Jersey corporation with its principal office at 745 Broad Street, Newark N.J. 07101.

21. Defendant Pension Benefit Guaranty Corporation is a United States government corporation established pursuant to ERISA § 4002, 29 U.S.C. § 1302. It administers the retirement insurance program provided for in ERISA Title IV, 29 U.S.C. § 1301 *et seq*.

22. At all times hereinafter mentioned, each of the Harper and Row defendants was a fiduciary of the Retirement Plan, the Profit Sharing Plan, and the Employee Stock Plan, within the meaning of ERISA § 3(21), 29 U.S.C. § 1002(21), and was a "party in interest" as to such Plans within the meaning of ERISA § 3(14) 29 U.S.C. § 1002(14).

23. Between February 1, 1981 and a date in December, 1981 when the MST stock was sold to Harper and Row, the MST defendants were fiduciaries of the Retirement Plan and the Profit Sharing Plan, within the meaning of ERISA § 3(21), 29 U.S.C. § 1002(21), and were parties in interest as to such Plans within the meaning of ERISA § 3(14), 29 U.S.C. § 1002 (14).

24. In or about August, 1981, defendant Prudential, by virtue of assuming the obligation to pay the accrued benefits of participants and beneficiaries of the Retirement Plan, became a fiduciary of the Retirement Plan within the meaning of ERISA § 3(21), 29 U.S.C. § 1002(21), and a party in interest to the Retirement Plan within the meaning of ERISA § 3(14), 29 U.S.C. § 1002(14).

Jurisdiction

25. (a) Claims I - IX are brought and arise under ERISA §§ 403-406, 409, 502(a), 4041(a) and 4044, 29 U.S.C. §§ 1103-06, 1109, 1132, 1341(a) and 1344, and this Court has jurisdiction of such claims under ERISA § 502(e), 29 U.S.C. § 1132(e).

(b) Claims X and XI are brought and arise under ERISA §§ 4041, 4044 and 4047, 29 U.S.C. §§ 1341, 1344, and 1347, and this Court has jurisdiction over such claims under ERISA § 4003(f), 29 U.S.C. § 1303(f).

(c) Claims XII and XIII are brought and arise under section 17(a) of the Securities Act, 15 U.S.C. § 77(a), §§ 10(b) and 14(a) of the Exchange Act, 15 U.S.C. §§ 78j(b) and 78n(a) and Rules 10(b)-5 and 14(a)-9, 15 C.F.R. §§ 240.10(b)-5 and 240.14(a)-9, promulgated by the Securities Exchange Commission thereunder. This Court has jurisdiction of such claims pursuant to Securities Act § 22, 15 U.S.C. § 77v, and Exchange Act § 27, 15 U.S.C. § 78aa.

(d) Claim XIV is brought and arises under New York General Business Law § 352-c. This Court has jurisdiction of such claim under the doctrine of pendent jurisdiction.

Allegations Common to All Claims

26. The Retirement Plan is an employee pension benefit plan of the defined benefit type within the meaning of ERISA §§ 3(2) and 3(35), 29 U.S.C. §§ 1002(2) and 1002(35). It is sponsored by Harper and Row, which, prior to the purported termination of the Plan hereinafter described, made contributions to the plan over a period of years for the purpose of providing retirement benefits to participants and beneficiaries of the Plan. The Retirement Plan was administered by a Retirement Plan Committee, the members of which were appointed by and subject to the control of the Board of Directors of Harper and Row. As of September 1981 the assets of the Retirement Plan totaled approximately $15,223,000.

27. The assets of the Retirement Plan were required to be held in a Trust Fund. Section 8.01 of the Retirement Plan provided, in part:

> No part of the Trust Fund, other than such part as may be required to pay taxes, administrative expenses and fees, shall by reason of any amendment or otherwise be used for or diverted to purposes other than for the exclusive benefit of Members and designated Beneficiaries.

28. Under Section 9.03 of the Retirement Plan, in the case of termination of the Plan by the employer, the Plan Committee was given "sole discretion" to allocate the Trust Fund to various categories of benefits payable under the Plan.

29. Under Section 9.04 of the Retirement Plan, in case of termination of the Plan, the Plan Committee was given discretion to terminate the Trust Fund. In such event the shares allocated under Section 9.03 were to be distributed to each individual either in "one lump sum" or "by the Purchase of a nontransferable annuity contract." The method of distribution for each individual was "in the complete discretion of the Committee."

30. The Profit Sharing Plan is an employee pension benefit plan of the individual account type within the meaning of ERISA §§ 3(2) and 3(34), 29 U.S.C. §§ 1002(2) and 1002(34). It is sponsored by Harper and Row. Under the terms of the Profit Sharing Plan, as it existed prior to the amendments hereinafter described, Harper and Row contributed 10% of its pretax profits to the Plan each year, and such contributions were allocated to participants in accordance with their total compensation from Harper and Row. Participants could elect to have the assets in their individual accounts invested in either a fixed income or equity fund managed by fiduciaries of the Plan. The Profit Sharing Plan is administered by a Profit Sharing Plan Committee the members of which were appointed by and subject to the control of the Board of Directors of Harper and Row. As of

November 1, 1981, the Profit Sharing Plan had approximately $3.5 million in assets, no significant amount of which was invested in Harper and Row stock.

31. In February, 1981 MST advised Harper and Row that it proposed to dispose of its holdings of Harper and Row common stock. The MST defendants and the Harper and Row defendants were all aware that whoever acquired such stock from MST would obtain effective control of Harper and Row. The MST defendants and the Harper and Row defendants were further aware that in the event that a third party hostile to the present management of Harper and Row acquired the MST stock, it was highly likely that such third party would elect or appoint new Directors and Officers of Harper and Row, and that, at a minimum, the Harper and Row defendants would lose their ability, as the incumbent management, to control the affairs of the company.

32. The Harper and Row defendants and the MST defendants thereupon entered into a scheme to prevent any third party from obtaining control of Harper and Row and to insure that the incumbent management of Harper and Row would retain control of the company for the foreseeable future. In general outline such scheme contemplated that Harper and Row would purchase the MST stock from MST, for an inflated price, and that the Harper and Row defendants would exercise their control over the Retirement Plan and the Profit Sharing Plan to enable Harper and Row to use the assets of such plans to finance the purchase of the MST stock. The Retirement Plan was to be terminated and the benefits payable thereunder upon termination were to be minimized through the use of arbitrarily chosen acturial assumptions so as to create excess or residual assets in the amount of approximately $9.8 million, which could then be

distributed to Harper and Row and used to pay for the MST stock. The Profit Sharing Plan would be amended, and its investment policy changed, to permit it to purchase from Harper and Row approximately $1.5 million in MST stock; the proceeds of the sale were to be used to pay MST for the MST stock. To insure that the Harper and Row defendants could maintain control of Harper and Row after purchasing the MST stock, the MST stock would not be held as Treasury Stock (in which case it could not be voted) but would be placed in a new Employee Stock Plan, where it would be under the control of a Trustee appointed by the Harper and Row defendants. Finally, the true purpose of all of the foregoing actions, namely the perpetuation of control of Harper and Row by its present management, would be concealed from employees and shareholders of Harper and Row through fraudulent communications designed to convince said employees and shareholders that actions were taken for their benefit.

33. Pursuant to such scheme the Harper and Row defendants and the MST defendants formulated, agreed upon, and caused MST and Harper and Row to engage in the actions described in paragraphs 34 through 57 hereof.

34. On or about September 15, 1981, Harper and Row entered into the Stock Purchase Agreement with MST, pursuant to which Harper and Row agreed to purchase the MST stock from MST. As an inducement to MST to enter the agreement, and to acquiesce in the other actions of Harper and Row described below, the purchase price for the stock was fixed at $20 per share, which was a level substantially above the price (approximately $10.50 per share) at which Harper and Row stock was then being traded, and was also substantially above the fair market value of the MST stock, even allowing for a reasonable premium based on the control of Harper and Row which the stock represented.

35. To finance the purchase of the stock from MST, Harper and Row took the following steps designed to permit Harper and Row to divert to its own use assets of the Retirement Plan and the Profit Sharing Plan:

36. In the case of the Retirement Plan, in or about August, 1981, Harper and Row acted to terminate the Plan and thereafter exercised its control over the Plan Committee to require the Committee to exercise its discretion to terminate the Trust Fund, and distribute to Harper and Row the excess assets in the Trust Fund not needed to pay benefits to participants and beneficiaries.

37. Harper and Row further exercised its control of the Retirement Plan Committee to require the Committee to use interest rates and other assumptions in calculating the present value of the accrued benefits payable to participants and beneficiaries of the Retirement Plan which were in themselves arbitrary, unreasonable, and deliberately chosen so as to minimize the present value of accrued benefits and thereby maximize the amount of residual assets to be distributed to Harper and Row as a consequence of the termination. In particular, an interest rate of 15% per year was chosen to determine the present value of accrued benefits. Such interest rate was grossly in excess of any reasonable actuarial assumptions as to long term interest rates.

38. The use of such a high interest rate resulted in an arbitrary, unrealistically low figure for the lump sum present value of each participant's accrued benefit because the present value of such accrued benefit is determined by discounting the value of the accrued benefit payable at age 65 by the interest rate factor for each year of the difference between the participants' current age and age 65.

39. Harper and Row further exercised its control of the Retirement Plan Committee to cause the Committee to require that all participants and beneficiaries of the plan receive their accrued benefits under the Plan in the form of a lump sum payment, rather than an actual annuity payable at age 65, if the present value of their accrued benefit was less than $250, and to give participants a choice between an annuity and a lump sum if the present value of their annuity was between $250 and $1,000.

40. Harper and Row was also aware that of those participants and beneficiaries who had a choice to accept a deferred annuity, payable at age 65, or a lump sum payment, many would choose the lump sum option. Since the lump sum payments were calculated based on the present values of the annuities, and such present values were set at arbitrarily low values because of the interest rate and other assumptions used to calculate them, the net result was to deprive most participants and beneficiaries of the plan of the true value of their accrued benefits under the plan, in order to maximize the amount of residual assets remaining in the Plan to be distributed to Harper and Row after paying such benefits to participants and beneficiaries.

41. In response to inquiries from participants and beneficiaries of the Retirement Plan, the Harper and Row defendants, or other management officials of Harper and Row, acting with the authority and consent of the Harper and Row defendants, informed such participants that the present values of their respective accrued benefits had been calculated using reasonable actuarial assumptions and were fair equivalents of the deferred annuities to which they otherwise would have been entitled to under the Plan. Such representations were false, and known to be false when made.

42. The foregoing actions were intended to, and in fact resulted in defrauding the participants and beneficiaries of the Plan of their accrued benefits under the Plan.

43. The Retirement Plan Committee's decisions as to the termination of the Trust Fund, the use of assumptions as to interest rates and other actuarial matters, and the form in which benefits were to be paid to participants, were all matters within the discretion of the Committee and as to which the Committee was bound to act prudently, and solely in the interests of the participants and beneficiaries of the plan. The Committee, at the behest of Harper and Row, deliberately and flagrantly violated such responsibilities in its actions regarding the termination of the Retirement Plan.

44. In or about August, 1981, Harper and Row, pursuant to ERISA § 4041, 29 U.S.C. § 1341, filed a written Notice of Intent To Terminate the Retirement Plan. Such Notice stated, as the reason for terminating the Plan: "The Plan is being terminated in order to institute a new defined contribution plan." This statement was false, and known to be false by Harper and Row. In fact, the reason for the termination, as described above, was to enable the Harper and Row defendants to use the residual assets of the Plan to pay for the MST stock and thereby perpetuate their control of Harper and Row.

45. In or about August, 1981, Harper and Row arranged to purchase, with assets of the Retirement Plan, what purported to be a guaranteed annuity contract from Prudential, pursuant to which all accrued benefits under the Plan would be payable either as an annuity at age 65 or in a lump sum. The premium payable to Prudential under the

policy, amounting to approximately $6,423,000, was treated by Harper and Row and Prudential as the cost of paying all accrued benefits under the Retirement Plan and was the basis upon which the remaining approximately $9.8 million in assets were treated as "excess assets" of the Plan which could be and were distributed to Harper and Row and used by it to pay for the MST stock.

46. Said premium was calculated based on an interest factor of 15%, and the lump sum payments purportedly equal to the present value of the accrued benefits of each participant and beneficiary were calculated based on the same 15% interest factor. At the time Prudential agreed to enter into the annuity contract it was known by Prudential and the Harper and Row and MST defendants that a 15% interest factor was grossly in excess of any reasonable actuarial assumptions as to long term interest rates and that Prudential would never be required to pay most participants and beneficiaries in the Retirement Plan an annuity, either because such participants and beneficiaries were only entitled to a lump sum or, even if entitled to choose an annuity, would opt for a lump sum payment, and would have no way of determining that the lump sum offered them as the present value of their accrued benefits was not, in fact, the true present value of their accrued benefits.

47. As to most of the participants and beneficiaries in the plan, the purported guaranteed annuity contract issued by Prudential to provide them with their accrued benefits was no more than a fraud and a sham and known to be such by all of the defendants, except defendant PBGC, in that most participants would not actually be paid any annuities thereunder but would instead be paid a lump sum

much less than the fair equivalent of their accrued benefits.

48. With the full knowledge and acquiesence of Prudential, the premium of approximately $6,423,000 quoted by Prudential for the purported guaranteed annuity contract was submitted by Harper and Row to the PBGC, and accepted by PBGC, as the amount of assets required to pay all of the accrued benefits to which participants and beneficiaries of the Retirement Plan were entitled. The information supplied to the PBGC prior to December 1981 did not disclose that the premium had been calculated on the basis of a 15% interest factor. Said fact was not disclosed to the PBGC until May 1982. On the basis of such premium, in December 1981 PBGC issued to Harper and Row a "Notice of Sufficiency". Upon receiving such Notice of Sufficiency Harper and Row was able to distribute the "excess" assets of approximately $9.8 million to itself for use in financing the purchase of the MST stock. If the lump sum values of accrued benefits under the Plan had been determined on the basis of reasonable interest rate assumptions the value of accrued benefits would have been much higher, and there would have been a corresponding diminution, or elimination of any "excess" or residual assets distributed to Harper and Row.

49. Upon information and belief, defendant Prudential was aware at the time it negotiated the guaranteed annuity contract that Harper and Row was deliberately attempting to minimize the amount which would be paid out to participants and beneficiaries under the Plan, in order to maximize the amount of residual assets which could be distributed to Harper and Row.

50. In the case of the Profit Sharing Plan, in order to obtain additional financing for the purchase price of the

MST stock, the Harper and Row defendants, with the full knowledge and acquiesence of the MST defendants, exercised their control of the Plan to amend it to eliminate the participants' right to elect the manner in which the assets in their individual accounts would be invested, to make future contributions by Harper and Row to the Plan discretionary (rather than a mandatory 10% of profits as previously provided), and to change the investment policy of the Plan by, among other things, requiring the Plan to purchase from Harper and Row approximately 100,000 shares of the MST stock it was to acquire under the Stock Purchase Agreement, and to prohibit the Plan's trustee from selling such stock without a specific direction to do so from the Board of Directors of Harper and Row. The price of the MST stock purchased by the Plan was approximately $1,500,000. Harper and Row intended to and did, in fact, use the proceeds of the sale to pay for the MST stock.

51. In acting to change the investment policy of the Profit Sharing Plan and, in particular, to require the Plan to purchase and hold approximately 100,000 shares of the MST stock, the Harper and Row defendants were not acting in the interests of participants and beneficiaries of the Plan; they did not make any investigation of whether said 100,000 shares of MST stock was equal to or superior to alternative investments (including the existing investments of the Plan which were sold to raise the cash necessary to pay for the MST stock); said defendants caused the Plan to acquire and hold said MST stock solely in order to help finance Harper and Row's purchase of the MST stock and to further their scheme of retaining control of Harper and Row and protecting their own positions as Officers and/or Directors of Harper

and Row, by ensuring that voting control of such stock remained in their hands.

52. The purchase of 100,000 shares of the MST stock by the Profit Sharing Plan was not a prudent investment of the assets of the Plan, and the requirement that such stock be held by the Plan unless its sale is authorized by the Board of Directors of Harper and Row is likewise not a prudent investment of the assets of the Plan.

53. Based on the market price of the stock on May 20, 1981, the Profit Sharing Plan has suffered a loss on the MST stock in excess of $250,000. This loss has been directly reflected in the valuation of participants accounts in the Plan.

54. In September, 1981 Harper and Row established the Employee Stock Plan, which is an employee pension benefit plan of the individual account type within the meaning of ERISA §§ 3(2) and 3(34), 29 U.S.C. §§ 1002(2) and 1002(34). In establishing the Employee Stock Plan, Harper and Row intended to contribute most of the MST stock to the Plan, to be allocated to participants in the Plan in accordance with a "target allocation" formula provided in the Plan. The target allocation formula is essentially an estimate, based on certain assumptions, as to what each participant would have obtained in benefits under the Retirement Plan and the Profit Sharing Plan had such Plans remained in effect, without the changes described above, through 1986.

55. The Employee Stock Plan further provides that each participant shall vest in the MST stock allocated to his account at the rate of 20% per year, and that all stock which is not vested shall be voted by the Trustees of the Plan.

56. Various management officials of Harper and Row have on numerous occasions represented to employees and shareholders of Harper and Row that the Employee Stock Plan is a bona fide tax qualified retirement plan designed to equal the benefits employees would have received under the Retirement Plan and the Profit Sharing Plan and to give employees an opportunity to share in the growth of Harper and Row. Such representations were false, and known to be false in that:

(a) The principal purpose of the plan is to serve as a vehicle to permit the Harper and Row defendants to maintain control of Harper and Row by exercising control over the voting of most of the MST stock. If said stock had been retained as Treasury Stock, it could not have been voted. By contributing it to the Employee Stock Plan, where it can be voted in accordance with the wishes of incumbent management, the Harper and Row defendants intended to discourage any third party from attempting to gain control of the company.

(b) The Employee Stock Plan is not a permanent plan; it provides only for one-time target allocation to employees; as such it probably will not qualify for favorable tax treatment under Section 401 of the Internal Revenue Code. In any event, it is not the equivalent of either the Retirement Plan, or the Profit Sharing Plan, which prior to their amendment were intended to be permanent, and permitted employees to plan their working careers at Harper and Row on the basis of accruing benefits under such Plans each year or so long as they worked at Harper and Row. By contrast, under the Employee Stock Plan, aside from the one-time contribution of the MST stock, there can be no expectation of further benefit accrual.

(c) The Employee Stock Plan will not and cannot replace the benefits employees previously were afforded under the Retirement Plan or the Profit Sharing Plan. Benefits under the Retirement Plan were fixed and were guaranteed; they were also insured by the PBGC in case the assets of the Plan were insufficient to pay them. Contributions to the Profit Sharing Plan were a definite percentage of profits and, more importantly, were invested prudently in a wide range of fixed income and equity securities. The fact that contributions were made out of Harper and Row's profits gave employees a full opportunity to share in the Company's growth, and if any further opportunity for employees to share in such growth was thought desirable by Harper and Row, it could have easily been provided in numerous ways, such as increasing the percentage of Harper and Row profits contributed to the Profit Sharing Plan, without jeopardizing the retirement security of employees by forcing them to accept a high-risk, speculative program in place of what had previously been provided to them.

(d) The estimates of the benefits which the participants and beneficiaries would have derived from participation in the Retirement Plan and the Profit Sharing Plan through 1986, which form the basis for the target allocation for each participant under the Employee Stock Plan, are demonstrably incorrect. Thus, the assumptions upon which the target allocation for each participant is to be calculated include the following:

1. Annual Compensation (as defined in the Profit Sharing Plan) increases at the rate of 8.5% per year.

2. A profit sharing contribution is made equal to 2.8% of Annual Compensation per year for the years ended April 30, 1982 through April 30, 1986 and earns a 9% compound annual rate of return.

3. Annuities are converted using a 9% interest assumption and the 1971 TPF&C Forecast Mortality Table on a Unisex Basis (50% male, 50% female).

4. Harper & Row Stock has a value of $13 per share at the time of contribution and a level compound rate of return of 8% (dividends only, no market appreciation).

These assumptions are arbitrary, unreasonable and inappropriate in at least the following respects:

(i) The assumption that salaries will increase at the rate of 8.5% per year is invalid because it is based on the further assumption that each participant will remain in the same job for five years. In fact, past experience demonstrates that many participants will be promoted to higher paying jobs over the course of five years, and will realize salary increases averaging substantially more than 8.5% per year.

(ii) The 9% interest assumption is arbitrary, unreasonable, and not within the range of acceptable actuarial assumptions, considering the nature of the Plan and the age of the participants. Use of a lower, reasonable interest assumption would result in each employee's target allocation being increased.

(iii) The value of $13 per share as the assumed value of the stock to be contributed to the plan was and is not reflective of the actual market value of the stock, either at the time it was (or will be) contributed to the plan, nor does it reflect the average value of the stock over a representative period of time. Defendants have chosen to use an arbitrarily high value for the stock because it serves to reduce the actual amount of stock necessary to be allocated to each participant's account to meet his or her target allocation formula. In effect, participants are being allocated stock actually worth $8 to $10 per share as if such stock were worth $13 per share.

(iv) Alternatively, by reason of the arbitrary and unreasonably high valuation of the stock to be contributed to the Employee Stock Plan, each participant in the Employee Stock Plan has suffered a loss in the value of his or her account in the Plan in the amount of approximately $5 per share of Harper and Row stock allocated to such account.

57. By reason of the foregoing, the Retirement Plan, the Profit Sharing Plan, the Employee Stock Plan, and all of the participants and beneficiaries of such Plans, have been substantially damaged.

CLAIM I

58. Plaintiffs repeat and reallege paragraphs 1 through 57 of this complaint as if set forth at length herein.

59. By reason of the foregoing, defendants, except defendant PBGC, have violated ERISA § 404(a)(1)(A), 29 U.S.C. § 1104(a)(1)(A) in that they have failed to discharge their duties as fiduciaries of the Retirement Plan, the Profit Sharing Plan and/or the Employee Stock Plan solely in the interest of the participants and beneficiaries of such Plan or Plans, and for the exclusive purpose of providing benefits to the participants and beneficiaries of such Plan or Plans.

CLAIM II

60. Plaintiffs repeat and reallege paragraphs 1 through 57 of this Complaint as if set forth at length herein.

61. By reason of the foregoing, defendants, except PBGC, have violated ERISA § 403(c)(1), 29 U.S.C. § 1103(c)(1), in that they have permitted assets of the Retirement Plan, the Profit Sharing Plan and the Employee Stock Plan to inure to the benefit of the employer.

CLAIM III

62. Plaintiffs repeat and reallege paragraphs 1 through 57 of this Complaint as if set forth at length herein.

63. By reason of the foregoing, defendants, except defendant PBGC, have violated ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(b), in that being fiduciaries of the Retirement Plan, the Profit Sharing Plan, and/or the Employee Stock Plan, they have failed to discharge their duties with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims.

CLAIM IV

64. Plaintiffs repeat and reallege paragraphs 1 through 57 of this complaint as if set forth at length herein.

65. By reason of the foregoing, defendants, except defendant PBGC, have violated ERISA § 404(a)(1)(D), 29 U.S.C. § 1104(a)(1)(D), in that being fiduciaries of the Retirement Plan they have failed to pay participants their accrued benefits under the Plan and have thereby failed to discharge their duties in accordance with the documents and instruments governing the Plan.

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CLAIM V

66. Plaintiffs repeat and reallege paragraphs 1 through 57 of this complaint as if set forth at length herein.

67. By reason of the foregoing the Harper and Row defendants have violated ERISA §§ 406(a)(1)(E) and 406(a)(2), 29 U.S.C. §§ 1106(a)(1)(E) and 1106(a)(2), in that being fiduciaries of the Employee Stock Plan they have caused said plan, not being qualifed under 26 U.S.C. § 401, to acquire and hold an employee security, namely MST stock, in violation of ERISA § 407(a)(2), 29 U.S.C. § 1107(a)(2).

CLAIM VI

68. Plaintiffs repeat and reallege paragraphs 1 through 57 of this complaint as if set forth at length herein.

69. By reason of the foregoing, defendants, except defendant PBGC, have violated ERISA §§ 406(a)(1)(D) and 406(b), 29 U.S.C. §§ 1106(a)(1)(D) and 1106(b) in that:

(i) said defendants, being fiduciaries of the Retirement Plan, have caused the assets of such Plan to be transferred to or used by or for the benefit of a party in interest as to such Plan;

(ii) said defendants, being fiduciaries of the Retirement Plan, have dealt with or have aided and abetted Harper and Row and MST to deal with the assets of the Retirement Plan for their own account, and have acted in a transaction involving the Plan, namely, the termination of the Plan and the distribution of its assets, on behalf of a party, *viz.* Harper and Row and MST, whose interests were adverse to the interests of the Plan or the interests of its participants and beneficiaries;

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(iii) the Harper and Row defendants, being fiduciaries of the Employee Stock Plan, have acted in a transaction involving the Plan, namely the contribution of the MST stock to the Plan, and the establishment of assumptions governing the value of said stock and other matters relevant to the determination of benefits under the Plan, on behalf of a party, viz. Harper and Row, whose interests were adverse to the interests of the Plan and the participants and beneficiaries thereof.

CLAIM VII

70. Plaintiffs repeat and reallege paragraphs 1 through 57 of this complaint as if set forth at length herein.

71. By reason of the foregoing, defendants, except defendant PBGC, have violated ERISA § 4044, 29 U.S.C. § 1344, in that upon termination of the Retirement Plan they failed to allocate the assets of the Plan to pay all benefits under the Plan, and distributed assets of the Plan to Harper and Row prior to satisfaction of all liabilities to participants and beneficiaries, and in contravention of law, namely, ERISA §§ 403(c)(1), 404(a) and 406(b), 29 U.S.C. §§ 1130(c)(1), 1104(a) and 1106(b).

CLAIM VIII

72. Plaintiffs repeat and reallege paragraphs 1 through 57 of this complaint as if set forth at length herein.

73. To the extent that any defendant, except defendant PBGC, did not actually perform any of the foregoing acts or omissions constituting a breach of fiduciary responsibility by any fiduciaries of the Retirement Plan, the Profit Sharing Plan

and/or the Employee Stock Plan, said defendant nevertheless (i) participated knowingly in, and knowingly undertook to conceal such acts or omissions, (ii) failed to comply with ERISA § 404(a)(1), 29 U.S.C. § 1104(a)(1) in the administration of his or her specific responsibilities which gave rise to his or her station as a fiduciary, and thereby enabled other fiduciaries to commit a breach, and (iii) failed to make reasonable efforts under the circumstances to remedy such breach; said defendant thereby violated ERISA § 405(a), 29 U.S.C. § 1105(a).

CLAIM IX

74. Plaintiffs repeat and reallege paragraphs 1 through 57 of this complaint as if set forth at length herein.

75. By reason of the foregoing, defendants, except defendant PBGC, have violated the Retiremet Plan in that they have caused the participants and beneficiaries of such Plan to be paid lump sum benefits less than the fair equivalent present value of their accrued benefits under such Plan.

CLAIM X

76. Plaintiffs repeat and reallege paragraphs 1 through 57 of this complaint as if set forth at length herein.

77. Defendant PBGC is responsible for administering the pension insurance program provided in Title IV of ERISA, 29 U.S.C. § 1301 *et seq*. One of its duties was to determine whether the assets of the Retirement Plan were properly allocated under ERISA § 4044, 29 U.S.C. § 1344, and in particular, to determine that all participants and beneficiaries of the Plan would be paid their accrued benefits, in full, prior to any distribution

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of residual assets to the employer. Under ERISA § 4041(a), 29 U.S.C. § 1341(a), no assets of the Plan could be distributed prior to the issuance by PBGC of a notice of sufficiency.

78. Defendant PBGC has adopted regulations, appearing at 29 C.F.R. § 2619.26(c), concerning the actuarial assumptions to be used in determining the value of lump sums and other alternative forms of distribution in lieu of annuities. Under such regulations defendant PBGC has the power to review the actuarial assumptions used by the plan administrator and "to re-value the benefits determined by the plan administrator if the actuarial assumptions are found to be unreasonable." Defendant PBGC has also adopted regulations, appearing at 29 C.F.R. § 2619, Subpart B, Appendix B, specifying the interest rate assumptions to be used for determining the present value of immediate annuities. The rate for immediate annuities valued on November 1, 1981, is 10.75%. Since interest rates in 1981 were substantially higher than long term average past rates, a reasonable interest rate for a deferred annuity would have been less than 10.75%.

79. Defendant PBGC failed to make any investigation of the true facts and circumstances pertaining to the termination of the Retirement Plan and accepted, without any inquiry, the premium quoted by defendant Prudential as the basis for determining the amount of assets necessary to pay all accrued benefits under the Plan. In particular PBGC failed to determie whether the interest rate upon which such premium was based was unreasonable and would result in a calculation of the present values of accrued benefits far below their true value for most participants and beneficiaries of the Plan.

80. On the basis of such quoted premium, and without determining whether participants and beneficiaries would actually receive the true value of their accrued benefits under the purported guaranteed annuity contract, PBGC issued a notice of sufficiency concerning the Retirement Plan to Harper and Row.

81. By reason of the foregoing, defendant PBGC, in issuing a notice of sufficiency to Harper and Row, acted arbitrarily and capriciously and in contravention of law, and its own published rules concerning the proper interest rate assumptions to be made for valuing accrued benefits.

CLAIM XI

82. Plaintiffs repeat and reallege paragraphs 1 through 57 of this complaint as if set forth at length herein.

83. Defendant PBGC is given broad discovery powers under ERISA § 4003(b), 29 U.S.C. § 1303(b), and is empowered under ERISA § 4047, 29 U.S.C. § 1347, to cease any activities undertaken to terminate a plan and to restore such plan to active status whenever it determines that such plan "should not be terminated as a result of such circumstances as the corporation determines to be relevant."

84. Through correspondence and protests from participants and beneficiaries of the Retirement Plan, and other information in its possession, PBGC knew, or should have known, that the termination of the Retirement Plan was part of a fraudulent scheme to deprive participants and beneficiaries of the Plan of their benefits thereunder and to divert the assets of the Plan for the personal use of the Harper and Row and MST defendants. The foregoing facts constituted circumstances

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which required the PBGC, as a matter of law, to exercise its power under ERISA § 4047, 29 U.S.C. § 1347, to cease the termination of the Retirement Plan and restore such Plan to active status. Defendant PBGC nevertheless failed to exercise such power, and its failure to do so was arbitrary, capricious, and a gross abuse of discretion.

CLAIM XII

85. Plaintiffs repeat and reallege paragraphs 1 through 57 of this complaint as if set forth at length herein.

86. The MST stock is a security within the meaning of the Securities Act § 2(1), 15 U.S.C. § 77b(1), and the Exchange Act § 3(10), 15 U.S.C. § 78c(10).

87. The purchases and sales of the MST stock hereinabove described were affected through the use of the United States mails and instrumentalities of interstate commerce.

88. By engaging in the foregoing conduct, the defendants, except defendants PBGC and Prudential, have employed a device, scheme and artifice to defraud; have omitted to state numerous material facts known in order to make the statements made, in the light of the circumstances under which they were made, not misleading; and have engaged in acts, practices and courses of business which operate or would operate as fraud or deceit on plaintiffs in connection with the purchase of a security, in violation of § 17(a) of the Securities Act, 15 U.S.C. § 77q(a); § 10(b) of the Exchange Act, 15 U.S.C. §78j(b) and Rule 10(b)-5, 15 U.S.C. § 240.10(b)-5, promulgated by the Securities and Exchange Commission thereunder.

CLAIM XIII

89. Plaintiffs repeat and reallege paragraphs 1 through 57 of this complaint as if set forth at length herein.

90. In or about November or December, 1981, the Harper and Row defendants, with the knowledge and consent of the MST defendants, issued a written proxy solicitation to all Harper and Row shareholders soliciting the proxies of such shareholders to enable management to vote their shares at the Annual Meeting of shareholders to be held on December 9, 1981, to approve the purchase of MST stock and the termination of the Retirement Plan, the amendment of the Profit Sharing Plan, and the establishment of the Employee Stock Plan, all as hereinabove described. Such proxy statement contained the following statements:

> The Board also recognized that if the Corporation were able to acquire the MST Shares on satisfactory terms it would have the opportunity to utilize such shares in connection with a restructuring of its employee benefit plans, which could provide employees with a greater incentive to continue in the Corporation's employ and a greater opportunity to participate on a long-term basis in its growth, thereby furthering the development of the Corporation's business.
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> * * *
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> As the purpose of the Employee Stock Plan is to provide participants in the plan with indirect ownership of a portion of the Corporation's Common Stock, it is expected that the plan will invest only in Common Stock and, to the extent that funds are held pending investment in Common Stock, in short-term investments (except as otherwise provided in the plan for participants who have left the employ of the Company with vested benefits). Accordingly, while the trustee of the Employee Stock plan will have authority for the investment of the assets of the plan, such authority will be limited. In this regard, the trust agreement relating to the Employee Stock Plan is expected to provide that the trustee shall not sell or otherwise dispose of any Common Stock held by the Employee Stock Plan except as required pursuant to the plan to provide benefits or as otherwise directed by the Board of Directors of the Corporation. See "Employee Stock Plan" below. As a purpose of

> the amended Profit Sharing Plan is, similarly, to give employees an interest in the success of the Corporation's business, the trust agreement relating to the Profit Sharing Plan, as amended, is expected to restrict the trustee of the plan, which will otherwise have authority for the investment of the assets of the plan, from selling or otherwise disposing of Common Stock without the direction of the Board of Directors of the Corporation except to provide for benefits pursuant to the terms of the plan.

91. The foregoing statements were, at the time and in the light of the circumstances then prevailing, false and misleading, in that they misrepresented the actions for which approval was sought as having been done to take advantage of an "opportunity" to benefit the corporation and its employees, when in fact, (a) the corporation did not, and could not, derive any benefit from the transaction; in reality it gave up valuable assets to pay for the MST stock and got nothing in return, (b) the employees of the corporation were substantially damaged by the entire series of actions, and (c) the sole purpose of the actions for which approval was sought was to benefit the Harper and Row defendants by giving them the means to maintain control of Harper and Row and thereby perpetuate themselves in office.

92. By reason of the foregoing, the Harper and Row and MST defendants violated the Exchange Act § 14(a) and Rule 14(a)-9. 15 C.F.R. § 240.14(a)-9, promulgated by the Securities and Exchange Commission thereunder.

CLAIM XIV

93. Plaintiffs repeat and reallege paragraphs 1 through 57 and 90 through 92 as if set forth at length herein.

94. By reason of the foregoing the Harper and Row and MST defendants have violated New York General Business Law § 352-c in that they have used or employed (i) fraud, deception,

concealment, suppression, and false pretense, and (ii) made representations or statements which were false, where said defendants knew or with reasonable effort could have known the truth, for the purpose of inducing or promoting the sale, purchase, or distribution within the State of New York of a security.

WHEREFORE, plaintiffs demand judgment granting the following relief against defendants:

1. The immediate appointment of a temporary receiver to take possession of the assets of the Retirement Plan, the Profit Sharing Plan and the Employee Stock Plan, and to administer the affairs of such Plans pending the entry of final judgment herein.

2. A mandatory injunction:

(a) requiring Harper and Row forthwith to reinstate the Retirement Plan, upon terms and conditions which fully recompense all participants and beneficiaries of the Plan for any loss they may have sustained by reason of the termination of the Plan, including, without limitation, all benefits that would have accrued to them through the date of judgment had the plan not been terminated;

(b) requiring all defendants, except defendant PBGC, to account to the Retirement Plan for the assets unlawfully diverted by said defendants from the Plan to their own use, including, without limitation, all of the residual assets of the Plan distributed to Harper and Row as a result of the termination of the Plan, and all funds which Harper and Row would have contributed to the Plan through the date of judgment had it not been terminated, with interest;

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(c) requiring all of the defendants to pay to any participant or beneficiary of the Retirement Plan who cannot for any reason be made whole through reinstatement of the Plan a sum equal to the difference between what such participant or beneficiary was previously paid and the present value of his or her accrued benefits under the Plan, determined on the basis of reasonable actuarial assumptions;

(d) requiring the defendant PBGC to take such steps as may be necessary or appropriate to carry out the foregoing;

(e) requiring defendant Harper and Row forthwith to amend the Profit Sharing Plan to restore said Plan to the form in which it existed prior to the amendments of the Plan in 1981, and to contribute to the Plan such amounts as it would have contributed had the Plan not been amended to make contributions discretionary;

(f) requiring the Harper and Row and MST defendants to account to the Profit Sharing Plan for all assets unlawfully diverted by said defendants to their own use, including, without limitation, all funds used to purchase any shares of MST stock, with interest;

(g) requiring the Profit Sharing Plan to sell any shares of MST or other Harper and Row stock it presently holds;

(h) requiring the the Harper and Row and MST defendants to pay to the Profit Sharing Plan a sum equal to (i) any loss sustained on the sale of stock required hereunder, and (ii) a reasonable rate of return which the Plan could have realized had it invested its funds lawfully and prudently instead of in the MST or other Harper and Row stock;

(i) requiring the Harper and Row defendants to recompute the account values of all participants and beneficiaries of the

Profit Sharing Plan whose accounts were diminished by reason of the Plan's investment in MST or other Harper and Row stock since February 1981;

(j) prohibiting defendants, except defendant PBGC, or anyone under their control, from voting, by proxy or otherwise, any shares of the MST stock, or any other Harper and Row stock held by the Retirement Plan, the Profit Sharing Plan, or the Employee Stock Plan, unless and until such stock is publicly sold;

(k) requiring Harper and Row to obtain Court approval for any amendment or other action, other than routine administration, pertaining to the Retirement Plan, the Profit Sharing Plan or the Employee Stock Plan; and

(l) permanently enjoining defendants from engaging in any actions violative of ERISA or federal and state securities laws.

3. Removal of the present named fiduciaries, and all other fiduciaries of the Retirement Plan, the Profit Sharing Plan, and the Employee Stock Plan who by reason of employment, stock ownership, corporate office or business relationship are subject to the influence, pressure, or control of Harper and Row or any other person whose interests are or may be inconsistent with the interests of the participants and beneficiaries of such Plans.

4. The appointment of permanent named fiduciaries of the Retirement Plan, the Profit Sharing Plan, and the Employee Stock Plan who are not under the control of any of the defendants, except defendant PBGC, including at least one fiduciary for each Plan to be designated by the collective bargaining

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representatives of the participants and beneficiaries of the Plan or otherwise selected by such participants and beneficiaries under such procedures as the Court shall specify.

5. Judgment for compensatory damages against the Harper and Row and MST defendants awarding to plaintiffs the difference between the assumed value of $13 per share of all stock contributed to the Employee Stock Plan and the fair market value of said stock.

6. Judgment for punitive damages against all defendants, except defendant PBGC, in favor of all participants and beneficiaries of the Retirement Plan, the Profit Sharing Plan, and the Employee Stock Plan.

7. Judgment awarding to plaintiffs the costs and disbursements of this action, including counsel fees.

8. Such other and further relief as to the Court may seem just and proper.

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NOTICE

Plaintiffs demand a jury trial on all claims so triable, as of right.

APPENDIX III

U.S. HOUSE OF REPRESENTATIVES,
SELECT COMMITTEE ON AGING,
Washington, D.C., December 15, 1981.

Hon. ROSCOE L. EGGER, Jr.,
Commissioner, Internal Revenue Service,
Washington, D.C.

DEAR COMMISSIONER EGGER: This letter is in reference to the recently announced decision of the Great Atlantic and Pacific Tea Co., Inc. (A & P) to terminate its present defined benefit pension plan and replace it with a defined contribution plan. Specifically, it has been reported that A & P plans to close an estimated 43 stores, principally in the New York metropolitan area. A & P, which has been experiencing financial difficulty for some time, indicates that these changes are a part of a revitalization program under which it would close or sell unprofitable stores and manufacturing plants, financing these arrangements and offsetting loses by drawing $200 million from the company's overfunded pension plan.

It is this latter aspect of the announced revitalization program which gives rise to some concern regarding the status of benefits for participants that are presently covered under the A & P pension plan.

Under the Internal Revenue Code of 1954 (the Code) section 411(d)(3), full vesting of accrued benefits, to the extent funded, is required upon the termination or partial termination of a plan. Moreover, it is a requirement pursuant to this section that if a sufficient number of employees are discharged during a period of economic decline by a company that a partial termination may occur which also would require that employees so discharged be fully vested in their accrued benefit. Under this provision, the Internal Revenue Service (the Service) must make a facts and circumstances determination as to whether a partial termination has occurred with respect to the plan.

Based upon the announced decision of A & P to terminate its pension plan and the economic decline which the company has experienced in the past several years and with the closing of a number of its stores and plants and the discharge of its employees covered under its pension plan, we request that the Service investigate this situation to determine whether there has been a partial termination of the A & P plan pursuant to section 411(d)(3) of the Code and the regulations. We would further request that all other pertinent provisions of the Code concerning the tax qualified status of this plan be examined to assure that the plan participants and beneficiaries of this plan are fully and fairly protected under these provisions of the Code.

We would further like to elicit the view of the Service, from a public policy standpoint, on voluntary termination situations similar to the one represented by the A & P plan termination. Members of the Select Committee on Aging (the Committee) are becoming increasingly concerned that many plans are adopting overly optimistic interest rate assumptions in order to lower the required contributions by employers to these plans. Plans may, through this same adjustment of assumptions, appear to have an excess of funding as compared to actuarial liabilities.

As in the instance of A & P, and certainly during this period of economic stress on many companies both large and small, the presumably overfunded plan may present an attractive reservoir of monies that are conveniently available to meet the employers' own priorities and needs.

We are concerned that voluntary terminations like the one represented by A & P may prove to be ultimately detrimental to the aggregate interests of plan participants and beneficiaries who are covered by such plans. For this reason we would like to have the views of the Service as to any specific legislative solutions that can be recommended regarding this problem.

Thank you for your assistance in these matters and we await your response to our concerns regarding Code section 411(d)(3) and with respect to the public policy considerations involving the voluntary termination of such overfunded plans.

With kindest regards.

Always sincerely,

CLAUDE PEPPER, *Chairman,*
MATTHEW RINALDO,
Ranking Minority Member,
GERALDINE FERRARO, *Member.*

DEPARTMENT OF THE TREASURY,
Washington, D.C., March 17, 1982.

Hon. CLAUDE PEPPER,
Chairman, Select Committee on Aging,
Washington, D.C.

DEAR MR. CHAIRMAN: This is in response to your letter of December 15, 1981, to Commissioner Egger concerning the termination of the defined benefit pension plan maintained by the Great Atlantic and Pacific Tea Co., Inc. (A&P). Assistant Commissioner Winborne referred your letter to us because it asked for legislative recommendations concerning voluntary plan terminations.

Your letter expresses the concern of Committee members that the use of inappropriate actuarial assumptions to determine funding for a qualified plan may result in underfunding that is detrimental to plan participants or to overfunding that encourages plan terminations. Your letter also expresses concern that voluntary terminations, such as the termination of the A&P plan, may be detrimental to the interests of plan participants and beneficiaries.

As you know, our tax laws provide employers with substantial incentives to establish and maintain qualified retirement plans on a voluntary basis. Employer contributions to such plans are, in general, deductible when made; qualified plan earnings are tax exempt; and taxation of plan participants is deferred until plan distributions are actually made. As a result of these three incentives, employer contributions to qualified plans will often generate more income to employees than will an equal amount of current compensation. Qualified retirement plans therefore become an important component of many employers' compensation package.

Although the tax laws provide employers with incentives to establish qualified retirement plans, the establishment of such plans remains a voluntary undertaking of the employer. Similarly, if an employer chooses to establish a qualified plan, the employer is free to determine the level of benefits under the plan, provided that the benefits are properly funded and do not discriminate in favor of officers, shareholders, or highly compensated employees. The employer cannot, of course, reduce the accrued benefits of plan participants. Finally, an employer may voluntarily terminate a qualified plan although the employer's obligation to fund accrued benefits remains. The voluntary nature of the qualified plan system enables employers to shape a compensation package that meets their needs and those of their employees. The voluntary nature of the system also enables employers to adjust their compensation package in light of changing economic conditions.

The income tax law already contains a number of safeguards designed to prevent abuse of the tax system through establishment or termination of qualified plans. Several of these safeguards are relevant to your specific concerns. First, plan benefits must be properly funded, and funding must be based on actuarial assumptions that are reasonable in the aggregate. Second, with limited exceptions, an employer is not permitted to reduce accrued benefits under the plan. Third, the assets of a defined benefit plan may revert to an employer only to the extent they exceed the amount required to fund accrued benefits and only to the extent that the surplus is attributable to actuarial error. The combination of these factors is designed to require that participants actually receive the benefits they are promised under a plan. To the extent funding exceeds this amount, it may revert to the employer. We believe that any rule to prohibit such reversions would discourage the establishment and proper funding of qualified plans.

We believe it is extremely important to continue to permit employers to terminate qualified plans voluntarily. Requiring employers to maintain a plan in perpetuity would deter employers from establishing qualified retirement plans while requiring that excess funding be allocated to employees would discourage employer contributions. Legislation of either type would lower retirement savings and the retirement security of plan participants.

Sincerely,

J. GREGORY BALLENTINE,
Deputy Assistant Secretary.

U.S. House of Representatives,
Select Committee on Aging,
Washington, D.C., January 15, 1982.

Hon. Raymond Donovan,
Secretary of Labor,
Washington, DC

Dear Secretary Donovan: This letter is in reference to the recent action of Harper and Row Publishers, Inc. wherein they have terminated their employee pension benefit plan and used a portion of the asset of that former plan to purchase over one million shares of the employer's stock that was previously held by the Minneapolis Star and Tribune. Specifically, it has been reported that Harper and Row, pursuant to this action, has terminated its pension plan and amended its profit-sharing plan, which together have provided funds for the purchase of the shares which have been placed in a newly created employee stock plan and the company's profit-sharing plan.

It has been reported that the defined benefit plan had $16.9 million in assets and $7.3 million in liabilities. The balance of $9.6 million was used for the purchase of the stock. The profit-sharing plan also used $1.5 million of its $3.5 million in assets to buy the stock.

The Select Committee on Aging is becoming increasingly concerned that a number of employers have or are contemplating the voluntary termination of their employee pension benefit plans in order to obtain excess plan assets to fund certain employer interests. The Committee is concerned that although the Employee Retirement Income Security Act of 1974 (ERISA) does not prohibit or otherwise proscribe the voluntary termination of an employee pension benefit plan, such terminations may be violative of certain of the fiduciary provisions of the law. Moreover, the Committee is concerned, that as a matter of public policy, an employer who voluntarily terminates an employee pension benefit plan solely to acquire excess plan assets to facilitate his own interests, is commiting an action which is adverse to the interests of the participants and beneficiaries of that plan and to the interest of the federal government and the public which seek to have pension plans established and maintained to provide for the economic security of American workers when they retire.

We understand that the Department of Labor has already commenced an investigation into the termination of the Harper and Row pension plan. The Committee wishes to obtain from the Department, after its completion, the results of its investigation into this matter. Specifically, the Committee wishes the Department to determine whether there has been any violation of the fiduciary provisions of Title I of ERISA. Moreover, the Committee wishes to know whether the Department has or intends to develop any specific guidelines, rules, or policies pertaining to a voluntary termination of an employee pension benefit plan where the employer realizes a substantial benefit through receipt and use of excess plan assets solely to further that employer's own interests.

Again, we are concerned that voluntary terminations similar to that represented by the Harper and Row termination may prove to be ultimately detrimental to the aggregate interests of plan participants and beneficiaries. During this period of economic stress, the overfunded plan may present an attractive financial reservoir for an employer to raid. Recent instances of the Grumman Corporation utilizing plan assets to stave off a corporate take over, which the Department has addressed, and the announced decision of the Great Atlantic and Pacific Tea Company (A&P) to voluntarily terminate its pension plan and convert $200 million in excess plan assets to restructure that company, point up our concern.

For this reason, we would like to have the views of the Department regarding instances of voluntary pension plan terminations which are ostensibly conducted to provide cash infusions to benefit the employer.

Thank you for you assistance in this matter and we await your responses to our legal and public policy concerns involving the voluntary termination of such overfunded plans.

With kindest regards,
Very sincerely,

Claude Pepper,
Chairman.
Matthew Rinaldo,
Ranking Minority Member.

U.S. DEPARTMENT OF LABOR,
SECRETARY OF LABOR,
Washington, D.C., April 26, 1982.

Hon. CLAUDE PEPPER,
Chairman, Select Committee on Aging,
Washington, D.C.

DEAR MR. CHAIRMAN: Thank you for your and your colleague's letter of January 15, concerning the voluntary termination of employee pension benefit plans and requesting the results of our investigation of the Harper and Row Publishers, Inc., Pension Plan (the Plan). I apologize for the delay in responding.

Concerning our investigation of the Plan, the New York Regional Office of the Department of Labor's (the Department) Labor-Management Services Administration has advised us that they are nearing the completion of their investigation of the Plan. Upon the completion of the investigation, their investigative findings will be transmitted to the Department's Pension and Welfare Benefit Programs, Office of Enforcement, for a determination as to whether violations of the Employee Retirement Income Security Act of 1974 (ERISA) have occurred. The Office of Enforcement will be happy to inform the Select Committee on Aging of the results of the investigation after its completion.

With respect to the Committee's inquiry and concerns about the distribution of plan assets after an employee pension benefit plan is terminated, section 403(c)(1) of ERISA provides in relevant part that, except as provided in subsection (d) of section 403 and under sections 4042 and 4044 (relating to the termination of insured plans and allocation of plan assets), the assets of a plan shall never inure to the benefit of any employer. Section 403(d)(1) of ERISA provides, in relevant part, that upon termination of a pension plan to which section 4021 does not apply at the time of termination (e.g., individual account plan) and to which Part 4 of Title I of ERISA applies, the assets of the plan shall be allocated in accordance with the provisions of section 4044 of ERISA, except as otherwise provided in regulations of the Secretary of Labor. The Secretary has not issued regulations under section 403(d)(1) and is not granted any authority under ERISA to prevent the voluntary termination of employee benefit plans. Section 404(a)(1) requires, among other things, that a fiduciary of a plan act prudently, solely in the interest of the plan's participants and beneficiaries, and for the exclusive purpose of providing benefits to participants and beneficiaries. In addition, the termination of an employee benefit plan and the distribution or transfer of plan assets must be done in accordance with plan documents and these documents must be consistent with the provisions of Title I of ERISA.

Until such time as distributions are made to participants in the form of benefits, the generally applicable rules of sections 403(c)(1) and 404 apply to the administration and management of plan assets regardless of the type of plan involved. This framework of rules is not subject to compromise during such events as plan termination and the transfer of assets from an existing plan to a newly created plan.

Section 407 and 408(e) of ERISA further define the ongoing responsibilities of plan officials with respect to the acquisition, sale, and holding of employer securities by subjecting such transactions to objective limitations and conditions.

In sum, transactions attendant to the termination of a pension plan are subject to all of the relevant provisions of Part 4 of Title I of ERISA.

It is also important to note in regard to the voluntary termination of most pension plans, that the Pension Benefit Guaranty Corporation and the Internal Revenue Service share responsibility for reviewing and approving the termination of pension plans.

I hope this letter is responsive to the Committee's concerns relating to the Plan and voluntary plan termination. If you have any questions on these matters, please contact me.

Sincerely,

RAYMOND J. DONOVAN.

THE GREAT ATLANTIC & PACIFIC TEA CO., INC.,
Montvale, N.J., June 14, 1982.

Hon. CLAUDE PEPPER,
Select Committee on Aging
Washington, D.C.

DEAR REPRESENTATIVE PEPPER: Our Company was invited to appear before the House Select Committee on Aging which held hearings on June 7, 1982 on issues relating to the funding of pension plans with specific reference to the announced intention to terminate the A&P Pension Plan. Although we appreciate very much the opportunity offered us to testify before the Committee, we declined to do so because the proposed termination of the A & P Pension Plan is the subject of litigation and we felt it was inappropriate to testify at your hearing while such litigation was pending.

The class action representative, Mr. William I. Walsh, did, however, testify at the June 7 hearing and in the course of his testimony made some serious misstatements that we believe must be corrected so as to set the Committee record straight. While we continue to believe that it would be preferable to avoid testimony on the subject of this litigation while it is pending, we also feel that Mr. Walsh's testimony has created an overriding need to have this letter included with the record of the hearings so as to correct the misstatements that presently appear in it.

With this preamble, we will proceed to address Mr. Walsh's misstatements.

Last Fall, A&P announced its intention to terminate its Pension Plan so that the substantial excess assets (of over $200 million) which will remain after full provision is made for all of the defined retirement benefits promised to and earned by Plan participants can be used to revitalize the Company and thereby preserve the jobs of literally thousands of Plan members as well as others. That action has been challenged and delayed by Mr. Walsh's lawsuit. The facts are as follows:

Since its adoption in 1948, A&P's Pension Plan has been a defined benefit plan to which all of the contributions have been made by A&P with the employees not contributing. The Plan promises its participants specific defined retirement benefits to the extent accrued (earned) and vested as to each participant. It has never been the intention of A&P or of the Plan, to generate a termination excess for allocation to anyone, or to create any inalienable employee right to any such excess. The amounts which A&P has contributed to the Plan have been in accordance with the recommendations made by the Plan's independent actuarial consultants (one of the premier actuarial consulting firms in America) in order to enable the Plan to meet (not exceed) these defined benefit obligations. However, due to the increase in interest rates and other unanticipated events of recent years, which varied from the actuarial consultants' assumptions, if the Plan were to now be terminated, the substantial surplus which is the subject of Mr. Walsh's suit would be present.

It is a well known fact that A&P has encountered serious business difficulties in recent years. It was to reverse this trend, and thereby save the jobs of its employees, that the recent decision to revitalize the Company was made. The only possible source for the approximately $200 million necessary to enable the program to succeed was the Plan surplus. It was concluded that the surplus could be used for this purpose so long as all "liabilities" of the Plan to its participants (*i.e.*, provisions for timely payment of their accrued defined benefits) were satisfied. The terminology and history of the Plan confirm this conclusion.

From the inception of the Plan in 1948 until September 1973, a period of over twenty-five years, the Plan had provided that, in the event of termination, any excess arising from erroneous actuarial computation and remaining after provision was made for satisfaction of liabilities to participants would be returned to the Company. ("Erroneous actuarial computation" simply refers to the difference between the Plan's actual requirements and those which were anticipated by its actuarial consultant in making contribution recommendations.

The surplus allocation provision was changed in September of 1973, not for the reason asserted to you by Mr. Walsh, but rather as a result of a corporate takeover attempt which was deemed by management to not be beneficial to the Company or its employees or shareholders. Mr. Walsh was not one of the drafters of this change. The persons who were—most of whom are now former A&P executives like Mr. Walsh and who would have everything to gain if his lawsuit were to succeed—have sworn, under oath, that the sole purpose of this 1973 change was (i) to deter an undesirable raider who might attempt to finance its takeover from the surplus then in the Plan and (ii) not intended to create a liability with respect to the Plan's participants. In this regard, it was expressly recognized that the Plan contained an extremely broad power of amendment so that the 1973 change itself remained amendable when and if management thereafter deemed it appropriate to do so. Consistent with this, while Plan participants were told of various other contemporaneous 1973 Plan changes (that did entail true liabilities to them), the change in the surplus allocation clause was not mentioned.

Less than two and one-half years later, effective January 1, 1976, the Plan was reamended to reinstate the original pre-1973 ("to the Company") surplus allocation clause. At this point, Mr. Walsh was no longer even on the Board of A&P. Despite this reinstatement of the pre-1973 surplus allocation concept, A&P's Corporate Secretary mistakenly certified that the Plan also contained an inconsistent provision as well. However, the only text of the Plan approved by the Board of Directors and Executive Committee of A&P in the manner provided by the Plan and effective on and after January 1, 1976 clearly stated that, in the event of termination, the surplus would be returned to A&P. It was to confirm this "to the Company" allocation concept and to eliminate any confusion arising from the Corporate Secretary's 1976 error, that the Plan was clarified by the amendment adopted in June of 1981.

Thereafter, in October 1981, the Board simultaneously determined that the proposed corporate revitalization program should be implemented and that the Plan should be terminated to permit the surplus to be used for that purpose and to provide for a new pension plan that would be more beneficial to most employees. When Mr. Walsh instituted his lawsuit, this termination was postponed and made contingent upon the resolution of his suit in the Company's favor.

It will be noted from the foregoing that Mr. Walsh's testimony contains a number of misstatements and misleading omissions. In addition, the following inaccuracies should be noted:

1. It is true, as noted by Mr. Walsh, that A&P has credited $130 million of overfunding to its 1981 earnings. However, Mr. Walsh is totally wrong in construing this as having occurred in anticipation that A&P will prevail in his lawsuit (although it is true that A&P clearly expects that to be the case). This credit is simply in recognition of the fact that late last year, due to current interest rates, A&P was able to secure annuities guaranteeing the Plan participants' accrued benefits at amounts much more favorable than were anticipated previously. A&P's independent auditors agreed that since this event gave rise to an extraordinary reduction in pension liabilities, it should be recognized immediately in the form of a one-time credit under applicable accounting rules. Even in the unlikely event that Mr. Walsh were to succeed in his effort to block A&P from securing the surplus, the overwhelming likelihood is that the Plan would continue and that the existing overfunding would still redound to A&P's benefit in the form of eliminated or reduced contributions by A&P to the Plan. The practice of ceasing or reducing contributions when the Plan is in an overfunded position, is entirely proper. Indeed, it has occurred regularly in the past, without any objection from Mr. Walsh while he was a director of A&P. The availability of this alternative highlights the fact that the Walsh litigation is essentially an obstructive measure which, even if it were to succeed (which it should not), would merely delay the beneficial effect of the current overfunding to A&P, while not aiding present or former Plan members one whit.

2. The number of Plan participants who have a crucial direct stake in A&P's continued viability and immediate receipt of the needed surplus assets, is far greater than portrayed by Mr. Walsh. His figures—26,000 retirees and former employees out of the 30,000 Plan participants who are active employees and who can benefit by having their employement prospects enhanced if A&P is permitted to take advantage of the excess now, rather than later, exceeds 9,000.

3. Mr. Walsh's statement that A&P will obtain the surplus tax free is incorrect. The Comapny will have to use tax loss carry forwards that could be used against future earnings. Additionally, as previously noted, the Company will have to start contributing (approximately $15 million a year), to the new pension plan, whereas by not terminating the existing Plan, the Company would derive the benefit of eliminating any such contributions.

4. The Company at no time made any promise that a termination surplus would be generated and allocated to any employee. The Plan booklet (which in any event, contained a clear warning that the official Plan text governed) contained no such promise and created no such right or expectation; indeed, the concept of surplus or excess was not even mentioned. To the contrary, as Mr. Walsh himself notes, the universal anticipation as to the instant Plan was that it would not terminate at all and as late as 1975, the actuarial reports indicate that if the Plan had been terminated, there would have been no surplus whatsoever. Obviously then, no employee could reasonably have relied on sharing in any surplus.

5. Mr. Walsh's allusions to A&P's stock ownership are irrelevant. A bare majority of A&P stock is owned by Tengelmann. That percentage of ownership was reached in 1980, not 1979 as claimed by Mr. Walsh. While it is also irrelevant, in 1979 (when Tengelmann had already acquired a large portion of its investment) and 1980, A&P made substantial contributions to the Plan. The 1980 contribution was eventually refunded after a determination by the IRS that it had been erroneously. This was proper and consistent with the previously-mentioned principle, often put into practice while Mr. Walsh was a director of A&P, of using overfunding to not make contributions.

6. Contrary to Mr. Walsh's assertion, A&P's Board of Directors includes several individuals who have no connection whatsoever with Tengelmann, including a

number whose tenure long pre-dates Tengelmann's investment. Each of these individuals participated in the unanimous vote of the entire Board to terminate the Plan so the excess could be used in the best interests of A&P and its employees. There is no basis whatsoever for Mr. Walsh's contention that the surplus will be paid out to stockholders. Further, this entire concept was initiated, not by Tengelmann or any other shareholder, but by A&P's own chief executive officer, Mr. James Wood.

7. Mr. Walsh's gratuitous expression of thanks to the Committee on behalf of "37,000 appreciative members of the Plan" presents a picture of unanimous support for his position that simply does not square with the fact that many Plan participants (including active Plan members whose jobs have been placed in jeopardy by his obstructive tactics) oppose his lawsuit and have sought to directly intervene in opposition to his claims.

8. Mr. Walsh refers to the "wide variety of responsibilities" which he was promoted to oversee at A&P and to his election as a senior corporate officer and director in 1971. He neglects to mention that in 1975, he was asked to (and did) step down from his position as a director; and that thereafter, most of his important job responsibilities were gradually eliminated until he eagerly grasped management's suggestion of a negotiated early retirement.

9. The proposed litigation settlement to which Mr. Walsh refers as allegedly "inadequate, inequitable and unreasonable" is for \$50 million of the surplus to be used to increase benefits for Plan participants; \$40 million for inactive participants; \$10 million for active employee participants. A&P is sympathetic to the situation which its retired and active personnel confront, and has long wished to be in a position of strong financial strength so that it could increase their defined benefits. Instead, the Company is struggling to revitalize itself. Despite this, and A&P's strong position in the Walsh suit, A&P agreed to the \$50 million figure because of its concern for its present and former employees, and because, although we believe it highly doubtful that Mr. Walsh can succeed, his lawsuit can cause a lengthy delay in the Company's receipt of needed funds.

10. Contrary to Mr. Walsh's present posture as to the proposed settlement, he not only initially agreed to it, but actively personally negotiated it. Mr. Walsh also neglects to mention that, shortly after the settlement was agreed to and announced, he arranged a press interview in which he reasserted a previously rejected demand that the settlement contain a guaranteed 15 percent across-the-board increase in benefits. Then, when it was demonstrated that, if the settlement were promptly implemented, it would indeed be likely to exceed that amount, Mr. Walsh not only raised the ante to a 20 percent demand, but also opposed one aspect of the settlement which would have given older retirees, who have smaller pensions to begin with, a monetary share of the settlement greater than that of their younger, more recently retired counterparts, in recognition of the higher pensions payable to the more recent retirees. (Since the older retirees by and large receive smaller pensions as a result of the lower wage levels in effect when they were working, a flat percentage increase to all participants as advocated by Mr. Walsh, would result in a smaller dollar increase for the older retirees than for the younger retirees).

The foregoing are just some aspects of the situation with regard to the A&P Plan which Mr. Walsh either misstated or neglected to mention at all in the course of his testimony before this Committee to which this statement is in reply. While A&P continues to believe that the proper forum for the resolution of these matters is the United States District Court, it believes that to remain silent in light of Mr. Walsh's presentation would be a disservice—to its shareholders, to its current and former employees and to this Committee.

Very truly yours,

ROBERT G. ULRICH,
Senior Vice President and General Counsel.

HARPER & ROW, PUBLISHERS, INC.
New York, N.Y. July 9, 1982.

Hon. CLAUDE PEPPER,
Chairman, Select Committee on Aging,
Washington, D.C.

DEAR MR. CHAIRMAN: I have returned the transcript of my testimony, with certain transcript corrections noted.

I would like to take this opportunity to supplement my testimony before the Select Committee on Aging to respond to certain matters raised at the hearing by District 65 that I did not have an opportunity to answer at the hearings.

In the statement submitted by Regina C. Little, of behalf of District 65, Ms. Little complained that the $343 cash lump sum offered by Prudential Insurance Company to Renee Cafiero was inadequate to provide the annuity promised by the Plan of $122 per month. Ms. Little alleges that Renee Cafiero was told by Prudential that her $122 annuity would cost in excess of $7,596. Ms. Little neglected to mention that Ms. Cafiero was given a choice between receiving the cash payment of $343 and the annuity. She selected the cash.

Ms. Cafiero stated during the hearing in answer to questions that District 65 had tried on several occasions to have meetings with the Company and had been turned down. The response was incorrect and misleading, as the following facts will demonstrate.

In August, 1981, when the agreement in principle was reached between the Company and Minneapolis Star & Tribune, the Company had house-wide meetings of all employees, including members of District 65, to announce the proposal. The essential details of the proposal were disclosed, including the fact that the pension plan would be terminated and that the excess assets of the pension plan after the payment of all accrued benefits, both vested and non-vested, would be used in part to finance the purchase from Minneapolis Star & Tribune. All persons present were encouraged to and many did ask questions.

The announcement was well received by the employees. Shortly after the meeting, the President of District 65 spoke publicly in favor of the proposal. While indicating that he wanted more information, the Union president stated (as quoted in Publishers Weekly): "It can only be mutually beneficial for employees to own stock in their company. I think it is admirable that Harper & Row turned to its employees rather than to a company that makes biscuits or tennis rackets."

The details of the employee stock plan and the method of allocating stock were worked out in consultation with a group of employees, approximately 40, who met regularly to consider questions of policy and arrive at decisions. District 65 did request to participate in those meetings. The group considered the request and debated the pros and cons at length, but eventually concluded that they did not want the meetings to be converted into a bargaining session, in view of the fact that the Union had expressly waived its bargaining rights with respect to the relevant charges, and that inclusion of Union representatives would inhibit the kind of open discussion which we hoped to and did achieve at the meetings.

However, all of the details of the allocation formulas were explained to all employees at meetings to which everyone, including union employees, was invited and at which questions were encouraged. Employees with individual questions were encouraged to raise them with the Personnel Department.

Moreover, the Company never declined to meet with the Union and in fact met with the Union promptly at their first request in December, 1981 (notwithstanding the fact, as noted above, that the Union had expressly waived its right to bargain over the charges). The December meeting was the only meeting requested by District 65. It lasted only a short time because the senior union representative present said he knew so little about the stock plan, he did not know what questions to ask. He asked us if the Company would respond to further requests for information. We assured him that we would be happy to do so. Only one request was subsequently made and that was for copies of a document that had been given to all employees.

In short, the Company did meet with the Union at their request, and the Company explained the proposals in detail to all employees, including Union employees, and gave all employees opportunities to ask questions and express their concerns.

Respectfully submitted.

Edward A. Miller,
Vice President and General Counsel.

Mittelman & Gordon,
Washington, D.C., June 16, 1982.

Re testimony before Select Committee on Aging, June 7, 1982.

Hon. Harold J. Daub,
Longworth House Office Building,
Washington, D.C.

Dear Congressman Daub: After my testimony on June 7, 1982 before the Select Committee on Aging, I learned that I may have inadvertently furnished an inaccurate response to one of your questions. Due to the press of business it was not possible for me to attempt to clarify this matter sooner. However, for the record, I would like to clarify my response.

As I recall it, the question that you raised had to do with the extent to which PBGC had a preferred creditor status with regard to the assets of an employer upon termination of the employer's pension plan. I replied that PBGC had a preferred status second only to that of IRS. I also pointed out that under the Multiemployer Amendments of 1980, the PBGC had been given general creditor status but of course, in that context the thirty percent net worth limitation that had previously existed had been eliminated. The point of your question, which I apparently missed, related to what PBGC's status would be if an employer had no net worth at the point of plan termination. My answer inadvertently assumed that there still existed a net worth.

In order to clarify this, therefore, let me acknowledge that currently in the single employer field, PBGC lacks creditor status in the event of the employer failing to have a net worth on plan termination. I understand that it has been proposed that PBGC be given general creditor status in the single employer field in the event the employer has no net worth. It is unclear to me, however, whether this general creditor status would be in addition to the priority status already given to the PBGC in the event the employer does posses a net worth or whether such a proposal is part and parcel of an effort to eliminate the net worth limitation, in which event the result would be symmetrical with the Multiemployer Amendments of 1980.

Giving PBGC general creditor status in addition to its already existing priority status when the employer has net worth would appear to create a doctrinal inconsistency. The more fundamental question is whether the net worth limitation should be retained because, if it is, it seems to me that employer insolvency is not an appropriate event warranting creating an additional creditor status for PBGC.

As I indicated in my prepared testimony, I am somewhat skeptical over the need to eliminate completely the net worth limitation insofar as the single employer field is concerned. If, however, the net worth limitation is eliminated in the single employer field, it would certainly seem appropriate to only provide PBGC with general creditor status. Those suggestions that have been made to eliminate the net worth limitation and at the same time give PBGC a preferred status in bankruptcy would, if implemented, probably dry up sources of credit for a substantial number of employers in the single employer defined benefit field. While I appreciate the concerns of those who advocate this course as a means of further insulating PGBC against ballooning premiums, etc., it would appear that the creation of such a "fail-safe" termination insurance system carries with it a potentially heavy price which may not be necessary to pay. In short, I believe that, at present, Congress ought to do only that amount of restructuring of the single employer insurance program that is absolutely necessary to provide adequate safeguards against the most obvious problems, such as "dumping," and inadequate premiums. Moreover, conscious efforts should be made to avoid accepting at face value apocalyptic interpretations of the problems confronting the single employer insurance program. If these crises occur, it is obvious that even the type of radical structural repairs to termination insurance being proposed may not be completely adequate. In fact, without some direct form of government intervention and support there may not be a satisfactory solution and under crushing economic pressures that would be true of almost any governmental insurance system, whether it is banking insurance, crop insurance, housing insurance, flood insurance, etc.

I hope that the foregoing helps to clarify more fully my views on this subject. I regret any misunderstanding that may have occurred as a result of my response to your question at the hearing and hope that this letter will serve to resolve any of the confusion that may have arisen as a result of my initial response.

Sincerely,

MICHAEL S. GORDON.

MITTELMAN & GORDON,
Washington, D.C., June 25, 1982.

Hon. CLAUDE D. PEPPER,
Chairman, Select Committee on Aging,
Washington, D.C.

DEAR CONGRESSMAN PEPPER: In reading over the transcript of my testimony on "Pension Funding Problems," of June 7, 1982, before the Committee, I noticed that one of my answers to a question you raised may not have been technically adequate, and I would like, therefore, for the record, to correct any inaccurate impression that may have been conveyed.

Your question related to what rights an employee with nine years of service had if the plan provided for vesting after completion of ten years of service, and the plan was terminated before the employee had completed ten years of service. My answer was that an employee who did not have vested status at the time of plan termination did not get anything but I meant to refer to insurance protection under Title IV of ERISA. In fact, under Section 4044 of ERISA, when a plan is terminated, its assets must be allocated to participants in the order of priorities enumerated in the statute until exhausted. The sixth priority enumerated in the statute includes non-vested participants, so it is possible that a non-vested participant with nine years of service could obtain some or all of the value of nine years accrued benefits if the plan terminated with sufficient assets to reach the sixth priority class of participants. On the other hand, if the plan's assets were insufficient for this purpose, such a non-vested participant would not be entitled under Title IV of ERISA to recover the value of his accrued benefits.

I hope the foregoing will clarify the situation.

Very truly yours,

MICHAEL S. GORDON.

STATEMENT OF THE AMERICAN ACADEMY OF ACTUARIES

On behalf of the American Academy of Actuaries, thank you for the opportunity to submit testimony in conjunction with the June 7th hearing of the House Select Committee on Aging on pension funding problems. This statement will respond to questions raised in a letter dated April 20, 1982 from Representative Claude Pepper to the American Academy of Actuaries.

The questions raised in Congressman Pepper's letter relating to pension funding are of deep concern to all actuaries in the United States, most of whom are members of the American Academy of Actuaries. We will limit our comments to those questions that are related to the actuarial profession. This statement will discuss the role of the actuary in regard to the funding of pension plans, the impact of the federal government on the funding of pension plans as viewed by our profession, and the growth of unfunded actuarial liabilities.

THE ROLE OF THE ACTUARY

At present, there are several professional designations for actuaries, each based on varying education and experience requirements. The classification most germane to pension funding is the "enrolled actuary." The Employee Retirement Income Security Act (ERISA) created the designation enrolled actuary; it requires that the applicant pass government-sponsored examinations and have experience in the field. There are other actuarial designations (i.e., a Fellow of the Society of Actuaries) in existence which require broader qualifications than the minimum standards set by ERISA. Enrolled actuaries are eligible for membership in the American Academy of Actuaries, and in fact, over 80% of enrolled actuaries are members of the association. The Academy has been active in promulgating standards of practice for actuaries working on pension plans. These standards, contained in the Academy's Year Book, are both pervasive and comprehensive.

The enrolled actuary is qualified to perform the various technical requirements to determine the actuarial liabilities, normal costs, funding requirements, funding standard accounts, and other determinations for pension plans. These requirements include the collection of appropriate data, the statistical studies that are necessary for mortality rates, disability rates, retirement ages, and other factors which will affect the cost of pension plans. In addition, it is necessary to study investments, inflation, and wage and salary increases in order to make reasonable estimates of the economics affecting pension plans. As a result of these studes and calculations, the actuary is in a unique position to advise plan sponsors on the funding of their pension plans. They can advise plan sponsors on the minimum and maximum amounts of contributions that can be made to the plan in order to meet requirements of ERISA or other sound objectives. The studies will also enable the actuary to advise the plan sponsor on the financial status of his plan, the projected costs and benefit payments, and other related financial matters.

In sum, the actuary possesses unique skills involving future probabilities of events which allow him to make reasonable estimates of the costs to meet pension plan commitments.

One of the determinations made by the actuary is the amount of the "unfunded actuarial liability" of the pension plan. The term "unfunded actuarial liability" has been used by both actuaries and the public to mean three distinct financial items. I will therefore define these three different and distinct items that have been classified as "unfunded actuarial liabilities."

The first item is the amount of the actuarial liability of the plan in excess of the actuarial value of the assets. There are several acceptable funding methods in use today to determine the actuarial liability of a pension plan. Without going into too great detail, a funding method is a system to divide the ultimate cost of the plan two costs—that allocated to service prior to the current date, and that allocated to service after that date. The latter is funded by a series of annual contributions called "normal costs," while the former is called the "actuarial liability." How this is divided depends on factors such as the weight given to years of service, prior earnings, coverage under the plan, and other items. ERISA mandates that these amounts be determined to establish the required contribution to the plan.

The excess of the actuarial liability over the actuarial value of assets is the "unfunded actuarial liability," a figure which appears in the funding standard account of ERISA. This is not a liability in the accounting sense (amount that is due and unpaid at any time); rather, it is a tool for providing a means to level out the future costs of a pension plan. Each year the company must contribute an amount equal to the normal cost of the plan, plus a sufficient amount to fund unfunded actuarial liability over not more than 30 years from its inception. A plan sponsor may also contribute up to the amount necessary to fund this unfunded actuarial liability over ten years from its inception. In this way it provides a plan sponsor not only a means of leveling out cost, but also provides flexibility so that somewhat larger or lower contributions can be made over time. Contributions within this range may be claimed as a tax deduction.

Increases in the unfunded actuarial liability occur when a plan is amended to provide increased benefits. Increases can occur also as the result of losses from the operation of the plan, e.g., the assets do not increase as expected, or participants live longer than anticipated. It should be emphasized that this item is a funding tool and does not measure the current financial status of the plan.

The second definition of "unfunded actuarial liability" is a measure of the financial status of the plan. In the profession, we prefer not to use the term "unfunded actuarial liability" for this figure, but rather we refer to it as the excess of the present value of accumulated plan benefits over the current value (market value) of the plan assets. In this context, we determine for each participant in the plan what benefits he can expect to receive in the future, and discount these benefits for the probability of receiving the benefits and for the expected interest earned between the current date and when the benefit must be paid. This then becomes the present value of accumulated plan benefits. Only the benefits that have credited up to the date of the calculations are included.

Comparing this present value with the current assets presents a picture of how well the plan is funded as of the valuation date. If assets equal or exceed the present value, all the credited benefits have been funded. The Financial Accounting Standards Board Statement No. 36 now requires that this measure of the financial status be included in a footnote of the corporate financial statement. This a statement of the financial condition as of a certain time. This figure also appears on Form 5500 which is filed under ERISA.

The third "unfunded actuarial liability" figure is a result of the Pension Benefit Guaranty Corporation. Under Title IV of ERISA, certain benefits are guaranteed to plan participants in the event of plan termination. These benefits are typically somewhat less than the plan's vested benefits. Thus, the third financial figure is the unfunded actuarial liability for pension benefits guaranteed by the PBGC. This figure is important to plans that are or may be terminated.

One of the questions raised by your Committee was the impact of high interest rates on the unfunded actuarial liability. First, consider the unfunded actuarial liability that is used for the funding standard account and discussed above. In selecting the assumptions to be used in valuing the plan, the actuary must be consistent. The economic assumptions with regard to wage and salary increases, investment income, and future inflation must be consistent with one another. If the actuary expects high investment rates, he will also anticipate high wages and salary rates, as both are related to high inflation. High investment rates will decrease pension plan costs. However, high wage and salary rates will directly or indirectly increase pension plan costs because pensions generally keep up with the levels of wages and salaries. Since higher investment rates decrease pension costs, and higher salary and wage rates increase pension costs, the two tend to offset one another.

The investment rate generally has a stronger impact than the salary rate, so that if both increase by the same amount, the net effect will be a decrease in the unfunded actuarial liability. However, the size of the decrease will vary significantly from plan to plan depending on the type of benefit formula, the extent the plan is funded, the proportion of participants who are retired, and several other factors. Therefore, the impact of higher interest rates will probably but not certainly decrease the unfunded actuarial liability, and the size of that decrease is unknown. (The above discussion assumes constant benefits in retirement. If a plan provides indexed benefits after retirement, then the effects are quite different.)

On the other hand, the impact of higher investment rates of return on the unfunded present value of accumulated plan benefits will more likely result in a decrease in the unfunded amount. Future wages and salaries and inflation generally do not affect the present value of accumulated plan benefits. Accumulated plan benefits represent the benefits that have been credited to the employees up to the date of the calculations. Future salaries and wages do not enter into these calculations. Thus, an increase in the investment rate of return is not offset by a corresponding increase in expected future wages and salaries. This is consistent with the requirements of Financial Accounting Standards Board Statement No. 35 and 36. If higher investment rates are expected in the future, it is quite likely that the current value of the assets in the fund will decrease.

There has been a significant problem with investing in bonds in the past several years. As interest rates have climbed, the value of the bonds in the pension portfolios have decreased significantly. Therefore, higher interest rates have lowered the present value of accumulated plan benefits but have also lowered the value of the assets. The difference betwen the two, the unfunded present value of accumulated plan benefits, could go either way, but generally results in a decrease.

THE ROLE OF THE GOVERNMENT

Prior to ERISA, the principal role of the government with respect to pension plans was exercised through the Internal Revenue Service, its tax laws and regulations. There were and are today two principal purposes for these tax laws. One is to limit the amount of contributions made to pension plans that can be claimed as a tax deduction. In actual practice, this is a tax deferral rather than a tax deduction since taxes eventually must be paid on these contributions. However, the Treasury Department was vitally interested in keeping large contributions from being made to pension plans and claimed as tax deductions. Thus, the maximum tax deductible limit was set to be the normal cost of the plan plus amortization of the past service cost in no less than ten years.

The second primary objective of these tax laws was to control the abuses that the Treasury Department perceived in private pension plans. These took the form of requiring broad coverage of pension plans and disallowing plans that were strictly for the benefit of highly paid personnel. The impact on the funding of the IRS laws and regulations was to inhibit somewhat the funding of pension plans. Many plans might have paid off their unfunded actuarial liabilities more rapidly if they had obtained tax deductions for these higher contributions. Also, any losses that occurred in the operation of the plan from any sources could not be made up by contributions at once, but again had to be spread over several years.

For the IRS, ERISA had small impact on the funding of pension plans. Plan sponsors are still prohibited from funding the unfunded actuarial liabilities faster than over ten years. The flexibility of the contributions that can be made to qualified plans remains, but it is somewhat more restricted in that the minimum contributions have been raised. Also, some new restrictions have been placed on the amount that can be contributed on a tax deductible basis under what is known as the Section 415 limits. This section limits the amount that can be contributed under defined benefit and defined contribution plans to certain maximum amounts. These are dollar amounts adjusted for inflation which cannot be fully advance funded because of certain technical requirements. While not major items, these are irritants in the funding of pension plans.

Generally, I believe ERISA has resulted in slightly stronger funding. However, whether in pre- or post-ERISA times, the real test of funding and a final answer to benefit security is the profitability of the plan sponsor. If the plan sponsor continues to operate on a profitable basis, the plan will be adequately funded, and all benefits will eventually be paid. However, businesses do terminate and pension plans do go out of existence. Hence, we have the PBGC to guarantee certain minimum benefits in the event that these plans are terminated.

It is interesting to note that a recent study has shown that 98% of all the plans that terminated had assets sufficient to cover all the benefits guaranteed by the PBGC. These results testify to the fact that the present stystem is providing adequate funding for private pension plans. Inadequate funding is the exception. It cannot be avoided in some circumstances in the early years of a plan or under adverse economic conditions.

THE ROLE OF THE ACCOUNTANT

The accountant's impact on the funding of pension plans, if anything, is only indirect. His particular role is the reporting of information of interest of plan participants, stockholders, and the like. However, through public disclosure of the financial status of the plan, the accountant does have indirect impact on how well the plan becomes funded. At present, Financial Accounting Standards Board Statement No. 36 requires that the following information be provided: (1) actuarial present value of vested accumulated plan benefits; (2) actuarial present value of non-vested accumulated plan benefits; (3) the plan's net assets available for benefits; (4) the assumed rates of investment income; and (5) the date at which the benefit information was determined. The sum of the first and second items minus the third item is the unfunded actuarial present value of accumulated plan benefits. These five items are shown in the footnotes to the corporate financial statements.

Accountants and actuaries have worked closely together to develop significant information for the public for many years. A committee of actuaries worked closely with the Accounting Principles Board back in the 1960s to develop Opinion No. 8. We have continued to work closely with the accountants to develop their various statements since that time.

INCREASE IN THE LEVEL OF UNFUNDED ACTUARIAL LIABILITIES

The Committee has asked us to comment on the increase in the level of unfunded actuarial liabilities. It is our opinon that generally, the increases that have occurred are not significant when they are related to the overall economy. Unfunded actuarial liabilities have increased in line with other economic indicators such as, for example, the increase in the size of home mortgages. Generally the increase is a result of having to increase the pension benefits in order to keep up with the current increases in salaries, wages, and cost of living. Many plan sponsors have increased the benefits to currently retired participants to assist them in keeping up with the increases in the costs of living. These benefit increases have resulted in increases in unfunded actuarial liabilities. As stated above, though, this is not of serious concern as long as the plan sponsors continue to remain profitable. Thus, the security of private pension plans is closely tied in to the total economy of the United States.

Increases in unfunded liabilities occur through two different events: (1) amendments to the plan which are a deliberate action on the part of the plan sponsor and, as indicated above, generally to keep the benefits current with current conditions; (2) losses due to adverse experience, which can result from unforeseen circumstances. These can arise because inflation was greater than expected or assets did not increase as much as anticipated.

SUMMARY

Thus, we can state the following: (1) the actuary, through his training and experience, reinforced by the profession and the laws is qualified to advise plan sponsors on the proper level of contributions to adequately fund their pension program; (2) pension plans generally are being adequately funded under the present laws; (3) some amendments to ERISA would improve the ability of plan sponsors to more rapidly fund their plans; and (4) in most situations, the growth in unfunded actuarial liabilities is not by itself a cause for alarm, but rather is the result of our overall economic conditions.

APPENDIX A.—BACKGROUND INFORMATION ON THE AMERICAN ACADEMY OF ACTUARIES

The American Academy of Actuaries is a professional association of actuaries which was formed in 1965 to bring together into one organization all qualified actuaries in the United States and to seek accreditation and greater public recognition for the profession. The Academy includes members of three founding organizations—the Casualty Actuarial Society, the Conference of Actuaries in Public Practice, and the Society of Actuaries.

The Academy serves the entire profession. Its main focus is the social, economic, and public policy environment in which the actuarial profession functions. Its primary activities include liaison with federal and state governments, relations with other professions, public information about the actuarial profession and issues that affect it, and the development of standards of professional conduct and practice.

Over 6,600 actuaries in all areas of specialization belong to the Academy. These members are employed by insurance companies, consulting actuarial firms, government, academic institutions, and a growing number of industries. Actuarial science involves the evaluation of the probabilities and financial impact that uncertain future events—birth, marriage, sickness, accident, retirement, and death—have on insurance and other benefit plans.

Membership requirements can be summarized under two broad headings: education and experience. At present, the educational requirements can be satisfied either by passing certain professional examinations sponsored by the Casualty Actuarial Society or the Society of Actuaries, or by becoming an enrolled actuary under the Employee Retirement Income Security Act of 1974 (ERISA). The experience requirement consists of three years of responsible actuarial work.

U.S. HOUSE OF REPRESENTATIVES,
SELECT COMMITTEE ON AGING,
Washington, D.C., April 20, 1982.

Mr. WILLIAM A. HALVORSON,
President, American Academy of Actuaries,
Washington, D.C.

DEAR MR. HALVORSON: The Select Committee on Aging of the House of Representatives has tentatively scheduled on Wednesday, May 26, 1982 at 10:00 A.M. in Washington D.C., a hearing concerning "Pension Funding Problems." The purpose of this hearing will be; (1) to explore certain problems associated with an increase in the level of unfunded liabilities which face a number of pension plans; (2) the recent voluntary termination or intention to terminate several large plans wherein an excess in plan assets were recaptured by the employee to purchase employer stock or otherwise advance the employer's business; and (3) to determine whether the financial solvency of the Pension Benefit Guaranty Corporation is threatened by the imminent bankruptcy of one of several large employers.

It is our hope that witnesses will include representatives of several of the affected pension plans, attorneys, accountants and actuaries expert in pension plans, representatives of the Department of Labor and the Internal Revenue Service and other noted experts knowledgeable regarding plan funding.

If you or members of your organization are able to attend, we would like your testimony to specifically address opinions 35 and 36 of FASB as they relate to the funding of pension plans, the role of the actuary in funding whether the minimum funding standards of ERISA and the funding standard account are effective in assuring the adequate funding of plans, the effects of high interest rates and inflation on funding. Also, there may be additional points which the Committee may wish you to address and we will subsequently contact you regarding these points if you are able to testify.

Certainly the Members of this Committee, the public and I will benefit from your expertise and insights on these problems. The Members of this Committee are anxious to elicit your views in contemplation of whether this Congress should take any specific action, whether through recommending legislation or through oversight of the appropriate federal agencies, to address this area of concern.

A member of my staff will be calling your office to discuss this request in greater detail. If you have any question, please contact Mr. Roger Thomas of the Committee staff at (202) 226-3355.

I appreciate that your schedule is extraordinarily busy however, I hope that you will be able to take some time from your work to address the Committee on this important topic. I look forward to seeing you on Wednesday, May 26.

With warmest regards,

Very sincerely,

CLAUDE PEPPER,
Chairman.

TESTIMONY BEFORE U.S. HOUSE OF REPRESENTATIVES SELECT COMMITTEE ON AGING

My name is Lawrence N. Margel and I am Vice President and Chief Actuary of Towers, Perrin, Forster & Crosby. Our firm is an organization of management consultants specializing in human resource, actuarial and selected general management services on a worldwide basis. TPF&C has been actively engaged in advising clients since 1917, when we designed one of the first private pension plans in the United States. Since that time, we have assisted hundreds of clients in the design and funding of retirement programs. Our professional staff includes over 250 actuaries, 111 of which have met the ERISA requirements for Enrollment.

One of the issues to be discussed today deals with the funding status of pension plans. Are the assets of pension plans sufficient to provide for benefits promised or do they fall short of being adequate to meet their commitments? Over the past few years, several articles have appeared that leave the reader to conclude that unfunded pension liabilities are a growing problem for American business and should be a concern to pension plan participants lest they lose their retirement benefits.

In discussing this issue, it is important that it be understood that in the pension world, "funding" is used in two ways. Its first use is as a verb and is equivalent to the word "contribute". Funding is what a company does when it makes its contribution to the trust that holds the assets for its pension plan. The second use of the word "funding" is as an adjective, as in "funding status". By this is meant the relationship of a plan's assets to the value of accumulated benefits. It is a balance sheet concept, whereas the first use of funding identified is an income-expense concept. This difference is easily understood by using an analogy of a conventional real estate mortagage. If a new homeowner secures a $30,000 mortgage for a 25-year period with an interest rate of 12 percent, he agrees to make monthly payments of $318.75. That is his funding commitment and the monthly expense with which he is concerned. After 10 years have passed, he will find that his unpaid mortgage balance has declined to about $26,000. That is his funding status.

Concerns raised about the funding status of pension plans are similar to the question "what is your mortagage balance?" Under the rules established by the Financial Accounting Standards Board, funding status is measured by comparing the market value of pension plan assets with the value of benefits earned to date. It is these numbers that are included in companies' annual reports.

The ERISA reports for 1979 for plans covering 100 participants or more showed that their assets were equal to 90 percent of their accrued benefit liabilities. Plans that were more than fully funded, had on average, assets equal to 133 percent of liabilities. Plans that were not fully funded had, on average, a 71 percent ratio.

Of the Fortune top 100 industrial companies, current year reporting shows that 64 out of 99 companies (one company does not have a defined benefit pension plan) are more than 100 percent funded with regard to liabilities for accrued benefits. On average, these plans are 125 percent funded. The 35 companies that are less than 100 percent funded are, on average, 84 percent funded.

A tabulation of 1981 results for TPF&C clients shows that plans are, on average, 113 percent funded, i.e., assets exceed the value of benefits accrued by 13 percent.

These three different sets of statistics lead to the conclusion that most private pension plans are well funded.

But how meaningful are these statistics? Let's go back to our homeowner and his $30,000 mortgage. His funding status after ten years showed a remaining balance of $26,000. While it might be of interest for him to know that, he is primarily concerned with the fact that his monthly payment of $318.75 will eliminate his obligation in 15 more years. It doesn't matter to him if his ten-year balance is $26,000 or $22,000 or $28,000. That information would be needed only if he were planning to sell his house. Similarly, the funding status of a pension plan is important only if it is expected that the plan will terminate. It is of no concern to a company, or a participant in that company's pension plan, unless plan termination is contemplated.

Companies are more concerned with their obligation for making contributions to the plan—their funding policy. In most cases, this funding policy is established so as to result in a future contribution pattern that remains stable either as a percentage of pay or in dollars per covered individual. The buildup of assets relative to liabilities for accrued benefits is only a by-product of this contribution philosophy. It is this concept that is pertinent in investigation why some pension plans are better funded than others.

While there are, of course, individual exceptions, generally plans that relate their benefits to earnings near retirement, so-called final pay plans, are better funded than non-pay related plans. The reason for this is simple. Nonpay related plans need frequent amendment to keep their benefit levels current in relation to pay. Final pay plans do not need amendment to achieve this result because it happens automatically through the plan's operation. It is not possible, under current IRS rules, for companies that sponsor non-pay related plans to provide for these amendments in advance. Final pay plans, however, base their current contributions on benefits that reflect future pay increases. Funding for those increases provides a faster build-up of assets, with the result being a better funded status.

Under the minimum funding standards of ERISA, a plan adopted today must, if it is not amended in the future, be funded over a 30-year period. Final pay plans are less in need of future amendment and are more likely to reach the 30-year mature state. Non-Pay related plans need frequent amendment with each newly adopted benefit being funded over its own 30-year period. Maturity is seldom reached and in fact, such plans suffer an immediate, instant decline in their funding status with each amendment. An amendment increases the value of benefits accrued as of its effective date, but it is not possible to provide an equivalent instantaneous increase in assets.

The reported figures for the measurement of funding status are heavily dependent on the assumptions used to convert future benefit payments to a current value. Rules of the FASB require that the interest rate used be a reflection of current market conditions. Many companies use the interest rates adopted by the Pension Benefit Guaranty Corporation for the valuation of terminating plans, or the rates used by insurance companies in setting premium rates for a current purchase of annuities. Higher current interest rates have resulted in the use of higher interest rates in valuing pension plan liabilities, lowering these amounts. This would result in a bettering of the funded ratios were it not for the effect of the higher marketplace interest rates on the market value of the plan's assets. These high current rates result in lower asset values, especially for plans that have a high proportion of bonds in their portfolios. While the effect of the current high interest rate market can be determined for any specific plan if one has access to all the needed detail; it is difficult to determine in the aggregate using material contained in annual reports.

Under ERISA, the assumptions used to determine a plan's contributions must be certified by the plan's actuary as being his best estimate of future experience. Clearly, the current high interest rate environment causes the actuary to reexamine his crystal ball to see what the future experience will be. While this may, in some cases, lead to an increase in the interest rate used for the determination of contributions, few, if any, actuaries assume that the present high rates will endure for over 50 years and that is the time frame over which actuaries make their calculations. Consequently, increases in the assumed rate of interest are of modest amounts and certainly not at the level of today's prime rate. Nevertheless, a continuation of high interest rates will inevitably result in the use of higher interest assumptions in the valuation of pension plans. This will happen because under present IRS rules, the actuary is bound to base his assumptions on the expected future experience. As that experience becomes realized, it must be recognized in the assumption setting process. Use of a low interest assumption, relative to the actual experience, will result in IRS disallowance of tax deductions for contributions to the pension plan.

While ERISA is concerned about adequacy of funding and defines minimum contribution requirements, the law is also concerned about excessive tax deductions. Rules of the IRS reflect that fact. For example, it is not possible to fund in a current year for events that will occur in the future, including a growth in the group covered by the plan, plan amendments, including adjustment to retiree benefits, and increases in the Section 415 maximum benefit limits, even though this last item is automatically indexed under the law. More rapid funding would result if these limitations were removed.

The myth that pension plans have generally low funding ratios is simply not true. It cannot be demonstrated by the published results, except for identifying certain companies with large dollar amounts of unfunded accrued benefit liabilities. For example, as of October 1, 1981, General Motors disclosed an unfunded liability for accrued benefits of $4.3 billion. This is certainly a large number, but their plans are 76 percent funded which is not a horrendous state of affairs.

Concern for the protection of pension rights should not be directed towards the present level of assets relative to the liabilities for accumulated benefits, but rather to the level of contributions being made to the plan and the ability of the sponsoring company to continue the contributions in the future. It is from this source that the retirement income security of employees is derived.

FINANCIAL ACCOUNTING STANDARDS BOARD,
Stamford, Conn., June 21, 1982.

Chairman CLAUDE PEPPER,
Select Committee on Aging,
Washington, D.C.

DEAR CHAIRMAN PEPPER: The Financial Accounting Standards Board (FASB) is pleased to comment in connection with the Select Committee's hearings concerning "Pension Funding Problems." Our comments relate primarily to the subject of generally accepted accounting principles (GAAP) and to the role of the FASB in prescribing accounting standards.

BACKGROUND ABOUT FASB

The FASB has been the recognized accounting standard-setting body in the United States since 1973. The FASB is an independent, seven-member board that operates under the oversight of a private foundation (the Financial Accounting Foundation) sponsored by six national organizations representing accounting academicians, certified public accountants, security analysts and investment advisors, corporate financial executives, management accountants, and investment bankers and brokers.

Statements of Financial Accounting Standards issued by the FASB establish new standards of financial accounting and reporting or amend those previously issued. Collectively, these standards reflect the continuing process of establishing and maintaining "generally accepted accounting principles (GAAP)" in the United States. FASB standards are officially recognized as authoritative by the Securities and Exchange Commission (Financial Reporting Release No. 1, Section 101). They are recognized under the code of ethics of the American Institute of Certified Public Accountants, and under the CPA licensing statutes, regulations, or practices of the 50 states. Further information about the FASB is contained in the enclosed "Description and Background."

FUNDING OF AND ACCOUNTING FOR PENSION PLANS

As indicated by its name, the FASB is primarily concerned with financial accounting and with the information presented in financial reports. Accounting is concerned with the elements of financial statements—assets, liabilities, revenues, expenses, gaining, and losses—and with the measurement, or quantification, of these elements. Accounting is concerned with providing information that is used to people who make economic decisions. These are the considerations that have guided the Board's deliberations on pensions. When a company sponsors a pension plan it incurs some amount of cost as a result. A company may also have an obligation for pension benefits earned by employees, but not yet funded. People who use the company's financial reports, including investors, creditors, and government officials, need to know about both pension costs and pension obligations as well as the amount of funds set aside to provide for benefits. The role of accounting is to provide that needed information. That requires the accountant, with the actuary's help, to measure the amount of pension cost and the amount of the obligation for benefits.

The actuary, on the other hand, is primarily concerned with funding, or establishing the amounts and timing of the employer's contributions needed to provide benefits to plan participants. Your concern with minimum funding and the minimum funding standard of ERISA most directly affects actuaries and plan sponsors. However, in seeking to understand the various factors that impact funding decisions, you will hear about accounting information and the confusion that exists, even among accountants and actuaries, between accounting and funding.

Both the accounting for pensions and the funding decision require estimates of future events that affect the amount of benefits that will actually be paid to retirees. These estimates include how many employees will survive to retirement age and how long they will live to collect benefits thereafter, to mention just two. These estimates or assumptions are made by the actuary and are used for both funding and accounting purposes.

Using the assumptions, there are two separate questions to be answered. First, the accounting question is how much pension cost and pension obligation have been incurred? Second, the funding question is, how much money should be set aside each year to provide for the ultimate benefit payments? The actuary may use any of a number of methods to establish a funding schedule or budget.

Some methods set aside relatively less now and make up for it with relatively larger amounts in later years. Others schedule approximately level amounts or level percentages of compensation in all years. The choice of methods is essentially a financing question. It is affected by many factors including the financial condition of the employer and the plan, available cash flows and other investment opportunities or needs, and legal requirements. It has been argued that employers and their actuaries need flexibility, at least within reasonable limits, in order to arrive at suitable funding schedules in different circumstances.

There is not compelling reason why all companies should fund exactly the amount of pension cost incurred each year. Some may choose to fund more and others less. But the amount of cost and the obligation incurred are important information that are a necessary part of financial reports. And the real cost of a pension plan is not changed by ...anagement's decision to fund a greater or lesser amount in a particular year.

The similarity of the basic problems tends to obscure an important distinction between funding and accounting. Similar calculations are involved, but each is guided by a different objective. The funding objective is to determine an acceptable pattern of cash outflows to the fund to finance the estimated ultimate cost of the pension plan. The accounting objective is to provide useful information, including information about the amounts of pension cost and obligation incurred as well as the amount funded. To be useful for purposes of making rational economic decisions, financial reporting information must be consistly determined from one period to the next, and to the extent possible should be comparable among business entities. Hence, the financial reporting objectives are better served by a narrower rather than a broader choice of methods, so that companies with similar plans (and thus, similar costs and obligations), do not report different results simply because they use different accounting methods.

FASB'S THREE PENSION PROJECTS

At the Select Committee's hearings references were made to pension accounting matters and as a result a brief background description of the FASB's three pension projects may be of interest.

The first of these, Statement 35, issued in March 1980, was developed with the cooperation of both the Department of Labor and the American Academy of Actuaries. Statement 35 establishes standards of accounting for the pension plan itself, something that previously did not exist. Financial statements of pension plans prepared in accordance with generally accepted accounting principles are required by ERISA.

Under Statement 35, the primary objective of a pension plan's financial statement is to provide financial information that is useful in assessing a plan's present and future ability to pay benefits when due. To meet this objective, the financial statements of the plan contain information about plan assets available for benefits and the benefits to be paid.

Statement 35 requires that plan investment be measured at "fair value," equivalent to market value where available. The Board believes that basis provides the most relevant information about the resources of a plan consistent with the primary objective of the financial statements. Required benefit information includes the actuarial present value of vested accumulated benefits and nonvested accumulated benefits expected to become vested. Accumulated plan benefits are those future benefit payments that are determined by the terms of the plan based on employees' service and compensation to date. Thus, accumulated plan benefits are one measure of benefits already earned by plan participants.

Statement 36, the second FASB pension project, issued in May 1980, requires employers to disclose in the notes to their financial statements, plan asset and benefit information determined in accordance with Statement 35. Hence, employers' disclosures about plan assets and obligations are being prepared on a comparable basis. Statement 36 was an interim solution designed to improve the usefulness of disclosures pending completion of the third project.

The third project, currently underway, is a long-range undertaking to reconsider accounting rules for measuring and reporting pension cost and pension obligations in the financial statements of employers. The project represents the first major reexamination of employers' accounting for pensions since the present standard became effective in 1967. We anticipate that completion is several years away.

The FASB appreciates the opportunity to comment in regard to the Select Committee's important undertaking. While we cannot speak directly to the question of adequate funding, we hope we have shed some light on the relationship between financial reporting and funding in the pension area. And we certainly stand ready to help in your committee's undertaking in way we can.

Very truly yours,

DONALD J. KIRK.

Enclosures.

FACTS ABOUT FASB

DESCRIPTION AND BACKGROUND

Since 1973, the Financial Accounting Standards Board has been the designated organization in the private sector for establishing standards of financial accounting and reporting. Those standards are, in effect, rules governing the preparation of financial reports.

The FASB's function is important because decisions regarding allocation of capital (investment) are based on financial information, much of which is the product of the financial accounting/reporting process.

FASB standards are officially recognized as authoritative by the Securities and Exchange Commission (Financial Reporting release No. 1, Section 101) and the American Institute of Certified Public Accountants (Rules of Conduct, as amended May 1973 and May 1979).

The SEC has statutory authority to establish financial accounting and reporting standards under the Securities Exchange Act of 1934. Throughout its history, however, the Commission's policy has been to rely on the private sector for this function to the extent that the private sector demonstrates ability to fulfill the responsibility in the public interest. The FASB was conceived by a special study group headed by a former SEC Commissioner and was carefully designed to carry out this responsibility.

The seven members of the Financial Accounting Standards Board serve full time. They have diverse backgrounds, but they must posses "knowledge of accounting, finance, and business, and a concern for the public interest in matters of financial accounting and reporting." Board members are appointed for five-year terms and are eligible for reappointment to one additional five-year term. Members and expiration dates (at December 31) of their current terms are:

Donald J. Kirk, Chairman—1986.
Robert T. Sprouse, Vice Chairman—1985.
Frank E. Block—1985.
John W. March—1984.
Robert A. Morgan—1982.
David Mosso—1982.
Ralph E. Walters—1983.

Members are required to sever all connections with firms or institutions they served prior to joining the Board. Mr. Kirk formerly was a partner, Price Waterhouse & Co.; Mr. Sprouse, professor of accounting, Graduate School of Business, Stanford University; Mr. Block, vice president, Bache Halsey Stuart Shields Inc.; Mr. March, senior partner, Arthur Andersen & Co.; Mr. Morgan, controller, Caterpillar Tractor Co.; Mr. Mosso, Fiscal Assistant Secretary, U.S. Treasury Department; and Mr. Walters, director of professional standards, Touche Ross International.

The role of the director of research and technical activities is considered equal in importance to that of members of the Board. The director is assisted by a staff of 45 professionals drawn from public accounting, industry, academe, and government. The staff works directly with the Board and task forces, conducts research, participates in public hearings, analyzes oral and written comments received from the public, and prepares recommendations and drafts of documents for consideration by the Board.

Due process

The Standards Board issues Statements of Financial Accounting Standards, Statements of Concepts, and Interpretations. Statements of Financial Accounting Standards establish new standards or amend those previously issued. Statements of Concepts provide a guide to the Board in solving problems and enable those who use financial reports to better understand the context in which financial accounting standards are formulated. Statements of Concepts do not establish new standards or require any change in existing accounting principles. Interpretations clarify, explain, or elaborate on existing standards. The FASB staff issues Technical Bulletins to provide guidance on applying existing standards to certain financial accounting and reporting problems on a timely basis.

Before it issues a Statement, the Board is required by its rules to follow extensive "due process" procedures which in many ways are more stringent than the requirements of the Federal Administrative Procedure Act.

In connection with each of its major projects, the Board takes the following steps: Appoints a task force of technical experts representing a broad spectrum of preparers, auditors, and users of financial information to advise on the project; Studies existing literature on the subject and conducts such additional research as may be necessary; Publishes a comprehensive discussion of issues and possible solutions as the basis for public comment; Conducts a public hearing, and Gives broad distribution to an exposure draft of the proposed Statement for public comment.

The Board's deliberations are open to the public, and a complete public record is maintained.

Issues resolved or under consideration

Among the significant and long-standing issues of financial accounting and reporting that have been resolved by the FASB are: accounting for research and development costs; self-insured losses; catastrophe losses incurred by property and casualty insurance companies; losses from expropriations of property by foreign governments; reporting by development stage companies; accounting for leases; segment reporting; capitalization of interest cost; accounting for defined benefit pension plans, and foreign currency translation. Other important projects on the Board's agenda include: the effects of rate regulation on accounting for regulated enterprises, accounting by employers for pensions and other retirement benefits, accounting for income taxes, and accounting for the reporting entity, including consolidations, the equity method, and related matters.

The philosophical basis of the Board's conclusions on specific accounting issues is the conviction that reported earnings should highlight differences in risk, not obscure them, and that similar situations should be accounted for in similar ways. While that philosophy has emerged case-by-case, the Board has perceived from its beginning the need to develop a consistent conceptual framework for financial accounting and reporting. One of the major reasons for recurring controversy concerning the accounting process has been lack of general agreement on such basic issues as the objectives of financial reporting, definition of the elements of financial statements and criteria for recognizing them, the bases of accounting measurement (historical cost of assets vs. current cost or some other method of reflecting the effects of inflation), and how to present information about income and cash flows.

In November 1978, the FASB issued a Statement of Financial Accounting Concepts on "Objectives of Financial Reporting by Business Enterprises," and in September 1979, a Statement of Standards on "Financial Reporting and Changing Prices." In 1980, three more Statements of concepts were issued: "Qualitative Characteristics of Accounting Information," "Elements of Financial Statements of Business Enterprises," and "Objectives of Financial Reporting by Non-business Organizations." All are significant parts of the continuing effort to construct a conceptual framework for financial accounting and reporting.

AN INDEPENDENT TRIPARTITE STRUCTURE

Financial Accounting Standards Board

The FASB is the operating part of a tripartite structure that is independent of all other business and professional organizations. The Board's 1982 budget is $8.6 million. Funds are obtained through contributions and sales of publications. Before the present independent standard-setting structure was created, financial accounting and reporting standards were established first by the Committee on Accounting Procedure of the American Institute of CPAs and then by the Accounting Principles Board, also an arm of the AICPA. Pronouncements of those predecessor bodies remain in force unless amended or superseded by the FASB.

Financial Accounting Foundation

The Financial Accounting Foundation, which is incorporated to operate exclusively for charitable, educational, scientific, and literary purposes within the meaning of Section 501(c)(3) of the Internal Revenue Code, is responsible for selecting the members of the FASB and its Advisory Council and for exercising general oversight (except with regard to the FASB's resolution of technical issues).

The Foundation also receives contributions and approves the FASB budget. More than half the funding is provided by industry and the financial community, with the remainder coming from the public accounting profession and other private-sector sources.

The Foundation is separate from all other organizations. However, its Board of Trustees is made up of nominees from six sponsoring organizations whose members have special knowledge of, and interest in, financial reporting: American Accounting Association (academe), American Institute of Certified Public Accountants (public accounting), Financial Analysts Federation (investors and investment advisors), Financial Executives Institute (corporate executives), National Association of Accountants, (primarily management accountants), Securities Industry Association (investment bankers and brokers).

There also is a trustee-at-large whose election was endorsed by the principal national associations in the banking industry. Members of the Board of Trustees are: Russell E. Palmer (President, FAF), managing director and chief executive officer, Touche Ross International; Kenneth S. Axelson (Vice President, FAF), executive vice president, J. C Penney Co., Inc.; Sidney Davidson, Arthur Young Professor of Accounting, Graduate School of Business, University of Chicago; William H. Dougherty, Jr., vice chairman, Southeast Banking Corporation; Paul J Dunphy, senior vice president-finance, Anchor Hocking Corporation; Thomas L. Holton chairman and chief executive, Peat, Marwick, Mitchell & Co.; Paul Lambert, Jr., CPA: Warren J. Robertson executive vice president-administration, Nabisco Foods Co.; Charles G. Steele, managing partner, Deloitte Haskins & Sells; Edus H. Warren, Jr, (Secretary-Treasurer, FAF) vice chairman, Capital Research Company; Hyman Weinberg, general partner, Goldman, Sachs & Co.; and George D. Anderson, senior partner, Anderson ZurMuehlen & Co., *ex officio.*

Financial Accounting Standards Advisory Council

The Financial Accounting Standards Advisory Council has responsibility for consulting with the Standards Board as to major policy questions, technical issues on the Board's agenda, project priorities, matters likely to require the attention of the FASB, selection and organization of task forces, and such other matters as may be requested by its chairman or the FASB chairman. The council has 38 members who are broadly representative of preparers, auditors, and users of financial information. Paul Kolton, former chairman of the American Stock Exchange, is Council chairman.

RELATIONSHIPS WITH THE FEDERAL GOVERNMENT

The Financial Accounting Standards Board is the designated organization in the private sector for establishing standards of financial accounting and reporting. Those standards are, in effect, rules governing the preparation of financial reports. The FASB's function is important because decisions regarding allocation of capital (investment and credit) are based on financial information, much of which is the product of the financial accounting/reporting process.

The FASB succeeded the Accounting Principles Board of the American Institute of Certified Public Accountants as the standard-setting body in 1973. The FASB is independent and separate from the AICPA and all other professional organizations. The standard-setting process is conducted under formal rules of procedure which require extensive public participation, including public hearings on major projects and issuance of proposed standards for public comment before adoption. All decision-making meetings of the Board are open to public observation.

The Board consults regularly with a Financial Accounting Standards Advisory Council of approximately 40 members who are broadly representative of all parties having an interest in financial reporting, including the federal government.

Because of the public implications of its work, the Board recognizes an obligation to maintain effective liaison with the federal government. The purpose is not to seek advantages, but to fulfill a public responsibility. Liaison is most active with, but not limited to, the Securities and Exchange Commission.

Relationship between FASB and SEC

Interaction between the FASB and government began in the Board's first year. The SEC has statutory authority under the Securities Act of 1933 and the other securities laws to develop financial accounting and reporting standards, but in its Accounting Series Release 150 (December 1973) the SEC recognized FASB pronouncements as authoritative accounting and reporting standards and announced that it would look to the FASB for leadership in establishing and improving standards. (In April 1982, ASR 150 was codified in SEC Financial Reporting Release No. 1, Section 101.)

The Standards Board and the Commission maintain close working relationships to foster cooperation and a climate that a former SEC chief accountant described as one of "mutual non-surprise." The Board members and the Commissioners meet together on a regular basis to discuss matters that are of concern to both bodies. The chief accountant of the SEC participates as an observer, but with the privilege of the floor, in quarterly meetings of the Financial Accounting Standards Advisory Council. Members of the chief accountant's staff are assigned to follow the development of specific FASB technical projects. They participate in meetings of advisory task forces on those projects and frequently observe meetings of the board.

The Commission often refers financial reporting problems to the Board for solution. When appropriate, the SEC has withdrawn its own rules after the Board has acted; for example, the FASB Statement on accounting for the effects of inflation replaced the Commission's replacement cost rule.

Only once has the SEC overruled the Board. That happened in 1978 when the Commission rejected the FASB standard for reporting by oil and gas producing companies. This was a special situation in which Congress (in the Energy Policy and Conservation Act of 1975) directed the SEC to develop a reporting system for oil and gas producers and explicitly permitted the Commission to rely on the FASB for accounting and reporting standards. The FASB issued such standards in 1977, within the time frame specified in the Act. After extensive consideration, including its own public hearings and those conducted by the Department of Energy, the SEC concluded in 1978 that existing accounting practices, including the one favored by the FASB, were inadequate. The Commission set out to develop a new system of "reserve recognition accounting," but in 1981 announced that it no longer considered RRA to be a potential method of accounting in the primary financial statements and that it would support an FASB effort to develop disclosure requirements for oil and gas producers. In April 1982, the FASB asked for public comment on its proposal. A final Statement is expected to be in place by the end of 1982.

Relationship between FASB and GAO

The General Accounting Office is another agency with which the Board interacts frequently. The Comptroller General is a member of the Financial Accounting Standards Advisory Council, and GAO staff often provide input to Board projects and participate in task force meetings.

Other relationships and issues

The pattern of FASB relationships with the federal government changes constantly, reflecting the issues that are of greatest urgency at any time. Current issues that are of mutual concern to the FASB and the federal government include accounting for inflation, pensions, tax leases, thrift institutions, regulated enterprises, and small businesses.

Inflation accounting

An FASB project that has stimulated interest in Washington for several years is the standard requiring large companies to report the effects of changing prices (inflation) on their business. During the development of the standard (Statement No. 33), which was published in 1979, the usual close liaison with the SEC was maintained. There also were extensive discussions with the Treasury Department and the IRS to work out a change in the LIFO conformity rules which would make it feasible for companies to use the new standard without concern about the effect on taxes.

After the standard was adopted, briefings were conducted for representatives of Treasury, IRS, statistical agencies of Commerce and Labor, the SEC and other independent regulatory agencies, bank regulatory agencies, and Congressional committees. The FASB chairman testified on the standard at a hearing on capital formation before the Joint Economic Committee. In addition, Board and staff meet often with interested government officials to provide current information about the results of Statement 33. The FASB is monitoring and studying the results for a five-year period with a view to making changes in the standard if a need is indicated.

Pensions

With enactment of the Employee Retirement Income Security Act (ERISA) came need for government to develop reporting and disclosure regulations. At the same time, the Board began its project to set standards for financial reporting by defined benefit pension plans. The FASB and the Department of Labor worked together to develop useful disclosures that would not impose unnecessary reporting burdens on administrators of pension plans. Again, the FASB chairman participated in numberous meetings and in the Department's public hearing. Pension issues continue to hold the attention of the Board and government. Currently, the Board is developing standards for accounting for pension costs by employers, and the Congress is considering legislation dealing with private and public pension plans. Board and staff have regular contacts with the Department of Labor, key Congressional committees, and others concerned with pension policy.

Tax leases

The 1981 Economic Recovery Tax Act is another Congressional initiative which necessitated action by the FASB. Shortly after the tax law was signed, the FASB began developing an accounting standard for purchases and sales of tax benefits through safe harbor tax leases. Following public comment on the Board's tentative conclusions, published within days after the Treasury issued temporary regulations, the Board revised its proposal and again asked for constituent views. The Board expects to issue a final standard for use in preparing 1982 financial reports.

Thrift institutions

Another emerging problem that has required close liaison between the FASB and federal policymakers is the plight of the thrift institutions. Board members and staff have met often with regulators of financial institutions to explore the relationship of accounting rules to proposed solutions to the problems of thrift institutions. The FASB continues to monitor this situation closely.

Regulated enterprises

The FASB is considering how to account for the effects of regulation of an enterprise's prices based on its costs (for example, in the case of a public utility). Representatives of several federal and state regulatory bodies have been participating in the FASB's efforts in this area, which are expected to result in a final standard by the end of 1982.

Small business

The FASB recognizes that financial reporting needs of small businesses may differ from those of other companies. Currently the Board is seeking to learn more about the information needs of users of financial statements of private and small public companies. That effort involves frequent contact with the Small Business Administration, the SEC's Ofice of Small Business Policy, and Congressional committees.

Oversight

Ongoing review of the standard-setting process by the trustees of the Financial Accounting Foundation, who have responsibility for appointing members of the FASB, raising funds, and exercising general oversight (except with regard to resolution of technical issues), has brought improvements in the Board's structure and procedures. Because the SEC has statutory responsibility for standards of financial reporting, the relevant oversight committees of the Senate and House also have reviewed the FASB's performance on occasion. The FASB continues to have frequent contacts with those oversight committees as well as others handling issues which have implications for financial accounting and reporting standards. The Board keeps such committees informed with regard to the FASB's mission and progress on specific projects. In addition, the FASB provides lawmakers and regulators with timely information on matters relating to financial reporting which might assist them in their work.

The FASB's Washington office

The FASB headquarters are Stamford, Connecticut, approximately one hour from New York City and easily accessible to persons needing to visit the Board. To improve communication with government, the Board, in 1978, opened a small Washington office and added a Government Relations Manager, Patricia Pride, to its staff. The Washington office is able to provide FASB documents and other information to the Congress, executive departments, independent federal agencies, and other interested parties on request. The office also is prepared to arrange for the FASB to provide input to federal officials on specific subjects about which the FASB has special knowledge.

The address of the Washington office is Suite 509, 1129 20th Street, N.W., Washington, DC 20036, and the telephone number is 466-8016.

ERISA INDUSTRY COMMITTEE (ERIC),
Washington, D.C., June 16, 1982.

Hon. CLAUDE PEPPER,
Chairman, Select Committee on Aging,
Washington, D.C.

DEAR CHAIRMAN: Enclosed for the record is a statement by The ERISA Industry Committee (ERIC) in connection with the June 7, 1982, hearing by the Select Committee on Aging on Pension Funding Problems. It would be appreciated if this statement would be included in the record of the hearings.

Sincerely yours,

George J. Pantos,
Counsel for ERIC.

Enclosure.

Statement of the ERISA Industry Committee (ERIC)

This statement is presented by The ERISA Industry Committee (ERIC) in connection with hearings held on June 7, 1982, by the Select Committee on Aging. The ERIC statement is directed toward that portion of the hearing devoted to the provision of plan termination insurance by the Pension Benefit Guaranty Corporation (PBGC).

ERIC is an association of over 100 major corporations concerned with national retirement policy issues. ERIC's members include half of the nation's fifty largest industrial companies and represent a broad cross section of the nation's largest retailers, utilities, bankers and insurers.

After much discussion and also quite a bit of controversy, the idea of a pension benefit guaranty system came to fruition with the passage of ERISA in 1974. Specifically, Title IV of ERISA established the Pension Benefit Guaranty Corporation, a non-profit corporation whose purpose is——

(1) to encourage the continuation and maintenance of voluntary private pension plans for the benefit of their participants; (2) to assure the timely and uninterrupted payment of pension benefits to participants and beneficiaries under plans to which the title applies; and (3) to maintain premiums established by the corporation in accordance with the statute at the lowest level consistent with carrying out its obligations under law.

The proposal to increase premiums to $6.00 for the single employer pension plan termination insurance program raises the question of whether premiums are, in fact, being contained at the "lowest level." ERIC has a substantial interest in the level of premiums since major plan sponsors, such as those represented in ERIC, pay 85% of all premiums collected. However, more important than the issue of the level of the premium are problems involving the basic structure of the single-employer plan termination insurance program. When, in late 1977, a proposal was made to increase premiums from the original $1 level to the present $2.60 level, fundamental design problems were only beginning to surface. Accordingly, neither the Congress, the administering agency, of the community o' plan sponsors were able to effectively suggest solutions to those problems. In particular, the employer community supported the proposal to increase premiums to the level required for the program.

The present situation is dramatically different. Substantial problems with the design of the single-employer program have beeen identified, by the PBGC and by much of the employer community. Accordingly, it would be inappropriate to give attention only to a premium increase, while at the same time ignoring the corresponding problems of the single-employer program.

What are these fundamental design problems? First, there is a significant potential for abuse of the insurance system as the system is currently structured. Second, we are very concerned about structural defects with respect to both the level and scope of benefits guaranteed by the PBGC.

With respect to the potential for abuse, legislation is required which would prevent employers from "dumping" unfunded pension liabilities on the PBGC and, therefore, on the premium paying population. We strongly believe that certain provisions of H.R. 4330, the Retirement Income Incentives and Administration Simplifications Act of 1981, now pending before the House Education and Labor Committee, would plug loopholes which exist in the currrent law and would prevent such abuse.

Regarding PBGC guaranteed benefits, the current scope and level of benefits should be carefully reviewed. The level of guaranteed benefits provided under the program may be excessive. As a practical matter, except for the phase-in of benefit increases over the five-year period preceding plan termination, 100 percent of the nonforfeitable pension plan benefit is guaranteed by the insurance system. It should be noted that even the phase-in is sometimes rendered moot by the $20 minimum provisions under current law. In addition, since 1974, the scope of these guaranteed benefits has been significantly expanded by the PBGC through regulation.

These fundamental design problems have, we believe, resulted in a greater than necessary burden on premium payers. A five-fold increase in the premium requirement over a period of less than 8 years is truly significant and merits inspection.

Continued skyrocketing of insurance premiums could threaten the viability of the insurance system and could actually discourage, rather then encourage, the continuation and maintenance of voluntary private pension plans.

While we are particularly concerned with the effect of abuse of the insurance system and other structural defects of the single-employer program, we are also concerned that the proposed 130 percent increase in the premium rate is based upon certain suspect assumptions and methodology. More details in this regard follow later in this statement.

ABUSE OF THE INSURANCE SYSTEM

The present single-employer insurance program requires that a sponsor who terminates has defined-benefit plan must thereupon pay in a single sum any unfunded liability for guaranteed benefits, and turn over the plan to the PBGC to administer the plan's assets thereafter. This requirement has three significant problems:

(1) The single sum form of payment is too severe in some cases, since the deficiency will not be needed to pay benefits for many years, (2) the single sum payment is not enough in other cases, since it is limited to 30 percent of the net worth, and (3) the PBGC is introduced into every plan termination, even though the plan is already sufficiently funded in 98 percent of the terminations.

ERIC has supported for the last two years efforts to remedy the deficiencies of the Title IV program. Much of our proposal is contained in H.R. 4330, sponsored by Representative John Erlenborn. H.R. 4330 resolves the problems outlined by eliminating the 30 percent of net worth limit on liability; by allowing the sponsor to continue its association with the plan until all vested benefits are fully funded, in no more than 15 years; and by postponing the PBGC's active involvement until the sponsor is in bankruptcy or liquidation. This approach plugs the loophole through which several large employers have escaped within the past two years, paying 30 percent of a small net worth and dumping a large remaining unfunded liability onto the insurance system, while continuing to prosper in business and even operating a new pension plan that provides future benefits at the same level as the former terminated plan. H.R. 4330 further provides a reasonable interval over which the continuing employer can complete his funding and, it avoids the unnecessary administrative expenses associated with inserting the PBGC into every plan termination, even though only 2 percent are insuficiently funded, and some of those 2 percent are healthy companies. ERIC therefore heartily endorses this approach.

While we do not support all provisions of H.R. 4330 as currently drafted, we do not believe that any premium increase should be considered by Congress except as a component of a plan to correct the major Title IV deficiencies in ERISA that have been identified, and preferably with other changes to assure a sounder and stronger private pension system for our nation.

LEVEL AND SCOPE OF GUARANTEED BENEFITS

ERIC believes that there are elements of the current structure of the plan termination insurance program which can only lead to continuing cost pressures on the system. These cost pressures have resulted from both design flaws in the system, and also an unwarranted extension of PBGC coverage. Accordingly, ERIC proposes that before any increase in premium is considered, the current level and scope of guaranteed benefits should be carefully examined. Limitations in the level and scope of guaranteed benefits would improve insurance program design.

A. Level of guaranteed benefits

The guarantee of 100 percent of the vested benefit up to the current maximum level of $1,381 per month essentially represents a complete guarantee of pension benefits. ERIC does not believe that it was the intent of ERISA to provide total coverage to all plan participants, but to provide a fair level of protection of retirement income. Limitation of the level of guaranteed benefits by means of coinsurance would be far more desirable, from a program design standpoint, than the current structure whereby the entire burden of guaranteeing benefits under terminated plans is borne by the remaining plan sponsors through higher premiums. Covered employees should have no less an interest than participating plan sponsors in the sound funding and provision of pension benefits. This is accomplished through risk-sharing. It should be noted here that risk-sharing by employees is equitable in that the overwhelming majority of situations in which the PBGC must guarantee benefits result not from situations involving mismanagement of pension funds, where there would be a stronger case for the liability to be borne solely by the employer group (since it is the employer group which is responsible for investing plan assets), but from the failure of plan sponsors as a result of systemic factors which affect the economy and business, in which employees as well as employers are participants.

Cost-sharing among all parties to an insurance arrangement is a well-established and long-accepted principle. In almost any example of an insurance program available in this country, there is some element of cost-sharing by the insured party, be it through a copayment provision or limitation on benefits payable. Health,[1] general casualty, hospitalization and auto insurance all provide for some degree of coinsurance. But the PBGC guarantees have no similar provisions. Some cost-sharing arrangement would constitute better plan design. For example, initial hospitalization benefits are usually covered or reimbursed up to 100 percent and beyond some limit (generally based on a number of days coverage), benefits are covered by major medical at a percentage, usually from 70 percent to 80 percent of the total cost, with the insured party paying the remainder. ERIC believes adoption of a cost-sharing arrangement could significantly alleviate the escalating cost pressures facing the PBGC.

As an alternative to the current formula, the level of guaranteed benefits could be limited to an amount determined according to the years of covered service of the plan participant. For example, the guaranteed benefit could be determined, as in the case of multiemployer plans, as 100 percent of the first $5 of monthly benefit per year of service plus 75 percent of the next $15 of monthly benefit per year of service. Such a formula would introduce some coinsurance for lower paid participants, with a relatively larger coinsurance element for higher paid participants. Consider, for example, a lower paid employee who after 20 years of service would otherwise be entitled to a vested benefit of $150 per month, equivalent to an accrual rate of $7.50 per year. Under the above guarantee formula, such employee would have a guaranteed benefit of $137.50 per month, or 91.7 percent of his vested benefit. For an employee with a vested benefit of $300 per month after 20 years, accrued at a rate of $15 per year, the guaranteed benefit would be $250 per month, or 83.3 percent of the vested benefit. And, for an employee with a vested benefit of $500 per month after 20 years (accrued at $25 per year), the guarantee would be $325, or 65 percent of the vested benefit. As can be seen, this arrangement continues to provide extensive protection for those employees at the lower end of the benefit spectrum with a progressively increasing level of risk-sharing moving toward the high end, where employees may be expected to have greater resources to shoulder such risk.

Defining the level of the benefit guaranteed, as in the above example, has the additional effect of lessening the disparity of insurance coverage afforded under different plans. When in essence, fully vested benefits are guaranteed, the level of insurance coverage is based on the level of benefits provided under the plan. While higher plan benefit levels would generally indicate a somewhat greater potential liability for the PBGC, the related premiums remain at a flat rate regardless of benefit level. The above formula for guaranteed benefits would thus provide that the level of coverage would be more closely related to the structure of premiums.

Another alternative which should be considered is defining the guaranteed benefit as some percentage (less than 100 percent) of the vested benefit. This approach also has the advantage that coinsurance is a feature. In addition, it provides a certain indexing for guaranteed benefits as opposed to the previously cited formula under which the dollar amounts of coverage at 100 percent and at 75 percent were fixed (although these amounts could be indexed if desired). A disadvantage of this approach is that the level of coverage is different between plans.

B. Scope of guaranteed benefits

Also to be carefully reviewed is the definition of benefits guaranteed by the PBGC. It is ERIC's position, consistent with the original intent under ERISA, that the benefit to be guaranteed should be the normal retirement benefit or its actuarial equivalent. ERIC believes that the extension, by regulation, of the definition of guaranteed benefits to include early retirement supplemental, plant closing, and other non-basic benefits has added significantly to the financial problem the PBGC is facing. However, it is our understanding that the PBGC itself is unable to determine the cost effect of guaranteeing such extended benefits. ERIC would suggest that Congress direct, in examining this premium increase request, that, as a minimum, the PBGC be required to collect and make available data on the cost impact of guaranteeing benefits beyond the normal benefit (or its actuarial equivalent).

Even in the absence of empirical data, there is little doubt that significant expansion of the scope of guaranteed benefits is costly. When ERISA was passed, a specific distinction in the law between the basic benefits designated as guaranteed and those other classes of benefits that the PBGC was authorized to separately guarantee was made. ERIC feels this distinction has effectively been erased by the expansion of guaranteed benefits through PBGC regulations. In fact, no non-basic benefit guaranty program has ever been established or even proposed by the PBGC. As a result, employers have had to pay premiums for guarantees of benefits that they frequently do not even provide for their own employees. By expanding the scope of guaranteed benefits, those participants with basic nonforfeitable (or vested) benefits could be disadvantaged, to the extent non-basic benefits are elevated from a subordinated position to compete with the prior vested benefits with respect to the allocation of plan assets.

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[1] Indeed, the trend in reduction of cost-sharing in the area of health insurance has probably impaired the ability to contain health care costs.

Again, this expansion of the basic benefit engenders a similar problem as is evident when there is no coinsurance provision in the program—that there is a tremendous disparity among plans—and therefore plan participants—as to coverage, depending on the types of benefits provided under the individual plans.

It should be noted also that the expansion of the scope of guaranteed benefits can have an impact not only on the PBGC premiums, but upon plan sponsor funding as well. For example, in the auto industry, certain early retirement supplements are provided to employees who retire early with 30 years of service. These pension supplements, which are forfeitable in certain circumstances, were never intended by either the employers or the unions with which the benefits were negotiated to be prefunded and would generally not be payable in the event of plan termination. However, since these types of benefits can be guaranteed by the PBGC, the IRS has required that they be funded under the ERISA minimum funding standards. For General Motors alone, the additional cost of this prefunding requirement amounts to about $90 million per year.

C. A possible alternative

Additionally, there is a possible alternative relating to the maximum benefit guaranteed by the PBGC to alleviate the ongoing pressure on the PBGC premium rate. However, it should be clear that this alternative would not solve the fundamental design problems which are in need of being rectified.

Clearly, the setting of a limit on benefits was indicative of Congress' intent in this area, yet this intent has not been effectively carried out. The combined effect of the setting of the initial level and its escalation due to inflation have rendered the guarantee limitation virtually powerless. Due to inflation adjustments, the current maximum guaranteed benefit is $1,381 per month.

In the extreme case of an individual with 40 years of covered service under a flat dollar pension plan, this represents a benefit accrual of about $34.50 per month per year of service. This is in excess of the benefit accruals provided for under almost all pension plans in industry today and, of course, few participants reach 40 years of service. For a similarly situated individual covered under a pay-related plan, providing say 1% of final 5-year salary per year of service, an individual's salary would have to exceed $45,000 per year in order for the maximum benefit limitation to have any effect on the guaranteed normal retirement benefit. Relatively few individuals are at this salary level. Thus, the guarantee limitation has no real effect.

As a mimimum, Congress should consider a freeze on the maximum guaranteed benefit at its current level. Overtime, the maximum limitation will become effective on a phase-in basis, and eventually provide meaningful cost control.

BASIS OF THE REQUESTED PREMIUM INCREASE

As part of our comment on the proposed PBGC premium increase, we would like (for the moment) to focus our attention on the past and current operation of the plan termination insurance program under Title IV of ERISA. Although a detailed philosophy of premium requests has not been articulated by the PBGC, it would seem that this latest request represents a marked departure from guidelines used to formulate the 1977 request for an increase.

The PBGC has separated its premium requirements into four distinct categories. Without suggesting an order of importance, these categories are: (1) a provision for contingencies; (2) administrative expenses; (3) the cost of amortizing current unfunded claim liabilities; and (4) the projected level of annual claims in future years.

(1) *Provision for contingencies.*—ERIC understands that PBGC has stated that no provision for contingency reserves has been explicitly included in this latest request. We feel that, as a policy, this is appropriate given the stability of the base of premium payers and the mandatory nature of the program.

(2) *Administrative expenses.*—The level of administrative expenses is not a major contention, although ERIC notes that the current request indicates that administra-

tive expenses are now at a level which was initially felt would be sufficient to fund the entire termination insurance program when it was first established.

(3) *Amortization of current unfunded claim liabilities.*—A portion of the current $2.60 premium is intended to amortize past claims in excess of premium income. However, as of 1977, when the last premium increase was being discussed, the period over which losses were to be amortized was approximately 10 years, rather than the 5-year period underlying the current premium request. The 10-year period established in 1977 was purported to represent PBGC's estimate of the "dollar weighted" deferral period for those pension obligations for which it was to make payments. Now the PBGC is requesting that the amortization period be cut in half. It appears that there has been a major shift in philosophy for amortizing unfunded claims from 10 to 5 years without accompaning justification.

The 5-year amortization cost reflects almost $2.00 of the $6.00 requested. More than one-third of this $2.00 is attributable to the shift from a 10-year to a 5-year amortization period. ERIC does not feel that a 5-year amortization period is justifiable. Prior to ERISA, the shortest period over which private plan sponsors could amortize unfunded obligations was approximately 12 years. Even ERISA only shortened the period to 10 years.

We fail to see the need for a 5-year amortization period, especially in light of the previously mentioned mandatory nature of the program. At the very least, if it is decided that 5 years is the appropriate period, the Congress should schedule a premium decrease of $2.00 per participant, beginning 5 years after any increase. Once losses are amortized, there should be no further need to collect the amortization component of the premium, since the PBGC has not indicated a need for a contingency reserve.

At this point in our comments relating to the proper premium charge for amortizing unfunded claims, ERIC would like to express frustration in attempting to correlate the various estimates of obligations which the PBGC has reported. Just recently the PBGC released its report for fiscal year 1980. One item of note in that report was a decrease in unfunded claim liabilities of approximately $50 million during fiscal year 1980. Shortly thereafter, the PBGC indicated the need for a major premium increase. Then, the PBGC released its Annual Report for fiscal year 1981 which showed an increase in the unfunded claim liability of $94 million (nearly $60 million of which was due to one very large claim pending at the end of fiscal year 1981). To say the very least, this chronology of circumstances has caused considerable confusion.

Further on this point, the General Accounting Office has expressed its own reservations regarding the financial statements published by the PBGC. Some of ERIC members have indicated that a reading of a March 1982 report by the PBGC regarding of a March 1982 report by the PBGC regarding the proposed premium increase creates more confusion than enlightenment with respect to the basis for the premium request. One thing is clear—the basis of the premium request rests in part on financial reports and information which are subject to substantial questions—and. therefore, no premium increase can reasonably be put forward on this basis.

(4) *Premium requirements for future claims.*—Half of the premium request, or approximately $3.00, relates to PBGC's estimate for future claims. For the 1977 premium request, the PBGC attempted to related the level of claims incurred in any year to some fundamental economic cause. While there are many economic variables which may be strongly correlated to PBGC's claims level, a single variable was selected—the level of unemployment.

It is our understanding that the PBGC no longer feels that the unemployment rate is a reasonable basis for predicting its future claims. In fact, it no longer feels that any economic model is appropriate for the projection of claim experience. We would suggest that efforts to secure a correlation between the level of expected losses and economic activity be continued as the PBGC's claim experience matures.

To project claims for the $6.00 premium request, PBGC has suggested an approach wherein year-by-year experience is (in effect) plotted on a graph, and then some sort of line is drawn through the points. From that line, the PBGC contends that future claims can be extrapolated. While the use of trend line analysis is a common practice in forecasting, the validity of this forecasting tool rests upon two important principles: (1) the existence of a large body of data based on past experience; and (2) the ability to exclude significant statistical aberrations.

The statistical techniques which the PBGC has employed in projecting its future claims are not consistent with these principles. Much of the request for the premium increase is based on the questionable assumption that recent losses attributable to the termination of a single plan at the end of a projection period is a good barometer of the future. Furthermore, the $6.00 request is based not on the assumption that recent levels of claims will continue into the future, but that the trends in those levels of claims should set the level of premiums. As a result of the approach taken, the PBGC report projects a continued acceleration in the level of losses incurred each year to levels that become alarming.

ERIC does not believe that a trend analysis is an appropriate tool to use in setting premium levels for future claims. This is because there is a paucity of data and because any trend analysis is dominated by a single large claim recently incurred. The PBGC itself recognized that it was necessary to examine alternative approaches to establish the level of future claims. In fact, one PBGC alternative called for a premium of $4.70, rather than $6.00, a reduction of $1.30 from the recommended rate and nearly one-half of the $3.00 proposed to cover future claims. A case could be made that even the lowest premium level considered by the PBGC ($4.70) is unduly influenced by the single large claim. The PBGC has already included this single large claim in the proposed provision for amortizing past losses and it therefore doubly influences the premium request if it is included in the future claim provision as well.

SUMMARY AND CONCLUSIONS

On the subject of the premium itself, our opinion is that the request is based upon financial results and assumptions which are questionable and cannot be reasonably relied upon as the basis of a premium increase.

More importantly, however, substantial design problems have been identified under the single-employer plan termination insurance program. Specifically, the opportunity for plan sponsors to abuse the insurance system at the expense of other premium payers needs immediate legislative attention. If not remedied, hemorrhaging of the system is likely, and the prognosis for survival would be poor. In addition, there are certain problems in the area of guaranteed benefits. Significant reexamination of the structure of the basic benefit guaranty program is prescribed to relieve financial pressure on the insurance system. If these steps are not taken, we expect that empolyers would be further discouraged from continuing and maintaining voluntary private pension plans. That is, the health of the entire system could be jeopardized. Thus, much more critical than the acute problem of a purported need for a premium increase are the systemic ailments we have identified. No premium increase should be considered without addressing these systemic problems. And, if such problems are repaired, PBGC's financial position should improve quite dramatically.

Statement of Sophie M. Korczyk, Research Associate, Employee Benefit Research Institute

(The views in this statement are those of the author and do not necessarily reflect the views of the Employee Benefit Research Institute, its trustees, members or other staff)

PRIVATE PENSIONS AND THE PBGC: STRENGTH FOR THE FUTURE

Mr. Chairman, I am pleased to submit this statement for the record on the funding status of private pension plans.

This statement focuses on the growth of pension-plan assets, the funding status and other indicators of pension-plan financial health, and the role of the Pension Benefit Guaranty Corporation (PBGC) in assuring benefit security and plan integrity. Our research suggests that both the PBGC and the private system promise long-term financial stability. As the Congress debates issues concerning the Social Security system and private pension system, it is important that it do so on the basis of accurate data.

The growth of pension-plan assets

More than 28 million workers participate in defined-benefit plans. The PBGC's role in guaranteeing these workers' benefit security is more important than it has ever been, because defined-benefit plans are more important than ever. Defined-benefit plans represented 71 percent of all plan assets and a similar proportion of all plan participants in 1977. Over 15,000 net new defined-benefit plans have been formed annually since 1971. New defined-contribution plans are being formed more rapidly, and the assets in defined-contribution plans are also growing at a faster rate. The larger size of the average new defined-benefit plan, however, means that defined benefit plans will maintain at least their current share of the covered population for some time to come.

High rates of new plan formation have led to significant growth in pension-plan asset holdings as well. Between 1976 and 1981, private pension plan assets more than doubled in current dollar terms, reaching over half a billion dollars in 1981. Private pension growth has been significant even when the effects of inflation are taken into account. Between 1975 and 1980, pension plan assets grew at an average annual rate of 9.2 percent after adjusting for inflation. By comparison, state and local government pension plan assets grew 3.7 percent annually in real terms during this period. Private pension plans now provide nearly 9 percent of total credit available to financial markets and hold nearly a quarter of all corporate bonds and more than 12 percent of corporate equities.

The importance of pension plans in providing credit and investment resources promises to increase even further. Additions to pension reserves appear to have been one of the factors that kept savings rates from declining even more than they have in recent years. Pension plans may thus have helped to offset the detrimental effects of inflation on Americans' choices between spending and saving.

The financial health and stability of private pension plans

This growth in pension plan asset holdings has had a favorable impact on participant benefit security. Recently the Internal Revenue Service has made its pension-plan disclosure data available for public use, thereby providing researchers with data on the broadest and most representative group of pension-plans available anywhere.

Our tabulations of IRS data for the 1977 plan year—the most recent year for which data are available—suggest that the funding status of private pension plans is better than previous small-sample studies had found. Of the defined-benefit plans with 1000 or more participants—which account for more than three-quarters of all participants in defined-benefit plans—more than a fifth of multi-employer plans and nearly half of single-employer plans had assets equal to or greater than the value of their total vested liabilities. Of the plans with fewer than 1000 participants, a third of the multi-employer plans and more than half of the single-employer plans were likewise fully-funded or over-funded. And, with the exception of the larger multi-employer plans, from half to three-quarters of all defined-benefit plans are at least 75 percent funded.

Many large plans also appear to be well-backed by their sponsors' assets. More than 90 percent of the large corporate plans sampled in two recent studies had unfunded vested liabilities less than 20 percent of sponsor's net worth. Since the Pension Benefit Guaranty Corporation can claim up to 30 percent of a sponsor's net worth if a plan is terminated, such firms not only have no incentive to terminate their plans, but were they to do so, only they would bear the cost. Thus, the condition of the less than 2 percent of large plans with shaky sponsor backing isolated by Dr. Munnell is not an accurate picture of the other 98 percent.

What does underfunding mean to pension-plan participants? Does it mean that their benefits are unsafe? More likely, it means one of three things: Their plan has been enriched, providing higher benefits; some participants have received retroactive service credits; or actual plan experience has diverged from what the actuary forecast, necessitating adjustments in funding to amortize these differences.

Since the plan must amortize all of these changes over a period of time, funding is not likely to fully reflect them for a number of years. But the price of keeping plans fully-funded at all times could be foregoing benefit increases entirely.

Funding status, of course, is not the only measure of a pension plan's health or financial stability, though under current law it is probably the most important one for measuring society's potential responsibility for a plan. Other measures of plan financial condition include pension costs as a percent of wages and salaries, or the current cost burden of the plan to its sponsor, and plan investment returns. The smaller the plan's burden to the sponsor, the more likely the sponsor is to continue the plan, and the higher the plan's investment return, the lower the burden of the plan to the sponsor.

On both of these measures again, private pension plans display considerable strength. In plans with more than 100 participants, pension contributions average 7 percent of labor costs, rising to 37 percent of labor costs only in plans with 10 or fewer participants. To put these numbers in perspective, state and local governments contributed 17.5 percent of payroll to their pension plans in 1980, and the Federal government contributed over 30 percent of payroll to the Civil Service Retirement System and over 45 percent to the Military Retirement System.

Private plans appear to have outperformed most market indices in their capacity as investors of plan assets. The A.S. Hansen, Inc. Investment Performance Survey is the single largest survey of pension-plan investment performance, providing information on plans accounting for eight percent of all private plan assets in 1980. The newest Hansen survey shows that in the last ten years—which were devastating times for most financial asset holders—fixed-income funds matched or exceeded most indices of market performance. Equity funds failed to achieve this record, however, but did achieve returns at the upper end of the range of market indices. Pension fund managers could have bettered their investment performance throughout the last ten years by plunging their entire asset holdings into 90-day U.S. Treasury bills, but, even with perfect foresight, such a course would hardly have satisfied ERISA's prudence requirements.

The role of Federal benefit guarantees in maintaining benefit security

The Congress is currently re-evaluating the Pension Benefit Guaranty Corporation's role in the pension system. The PBGC was founded to guarantee benefits in defined benefit-plans and is doing its job very well. The corporation currently holds adequate assets to pay benefits in the plans it administers for many years into the future; total assets in the single-employer program at the end of fiscal year 1981 were more than ten times current annual benefit payments. The PBGC is trustee for 659 terminated plans, or less than one-tenth of one percent of all plans currently estimated in existence, and less than 2 percent of all the defined-benefit plans that have been terminated since 1974. Annual net claims against the Corporation have, however, been increasing, and at the end of fiscal year 1981 the Corporation reported an actuarial deficit of $188.8 million.

On the basis of its current deficit, the Corporation is asking the Congress to approve a 131 percent premium increase per participant per year, from the current $2.60 to $6.00. The Corporation argues that this premium increase would allow it to amortize its current actuarial deficit over five years as well as allowing it to accumulate reserves against projected increases in claims resulting from future plan failures. These future failures were forecasted by assuming the Corporation's net claims will continue growing at the same average annual rate experienced since the inception of the single-employer program.

Because of the size of the projected increase, because it is paid entirely by pension-plan sponsors, this rationale should be examined carefully. The projected premium increase would result in holding the PBGC to much higher funding standards for the liabilities in the plans it administers than any private plan would be allowed to meet under the Employee Retirement Income Security Act (ERISA) and applicable tax code provisions. No private plan facing a funding deficit would be allowed to amortize it over a period of less than ten years if it wished to claim tax deductions for the contributions. Likewise, no private pension plan would be allowed to fund its plan to provide benefits for employees not yet on the payroll, which is the equivalent of what the Corporation is asking the Congress to let it do.

Not only are there questions involved in asking plan sponsors to pay for events that have not yet occurred; there are also serious problems involved in forecasting these events. Nearly half the claims outstanding against the Corporation today arose from the termination of 8 large plans. Because there are relatively few large plans, and each of them faces a unique set of circumstances, their terminations are not as predictable as, say, the incidence of automobile accidents among groups of drivers.

Given the uncertainty surrounding plan termination forecasts, therefore, it is useful to explore the impact of alternative projections of future net claims on the private pension system. A recent PBGC staff research paper reviewed alternative measures of the Corporation's risk exposure and found that, depending on how risky plans are identified, the Corporation's exposure could range from over $600 million to $6 billion. Let us assume for a moment that the entire amount of claims forecast in the worst-case scenario were to occur at once, and that existing plans were to be assessed at once—not over a period of even five years—to make up this funding insufficiency. This assessment would amount to just over 1 percent of private-plan assets outstanding at the end of 1981. If, instead, this funding deficiency were to be amortized over 10 years, and, even if private-plan assets were not to grow at all over the next ten years, the assessment needed to fund this deficiency would be one-tenth of one percent of the assets of private plans each year.

We do not submit these arguments, Mr. Chairman, to dissuade the Congress from considering changes in the Corporation's premium structure, because such changes may well be warranted. We do conclude from our analysis, however, that the Corporation is far from insolvent, and that a compelling case has not been made for funding its liabilities this much in excess of private-sector funding standards.

CONCLUSIONS

The private pension system is strong and growing. Annual rates of net new plan formation have not only regained their pre-ERISA levels—they have surpassed them. In fact, the over 68,000 net new plans formed in 1981 exceeded the highest pre-ERISA annual total by more than 20 percent. While most of the new plans have been defined-contribution plans, defined-benefit plan growth has also been enjoying a resurgence. Current rates of inflation and the resulting increasing real burden of taxation will probably foster this growth as both employers and employees at all income levels seek to shelter income from taxation and maintain the real value of their retirement savings.

The ERISA legislation is only eight years old. Experience and the passage of time have pointed out some flaws in ERISA that should be corrected. As the Congress debates changes in the Social Security program and in legislation governing private pension operations it must, as you fully appreciate, do so on the basis of all the facts. Social Security, private pensions, and other sources of income, are all needed if we hope to meet our common goal of providing adequate retirement income. Those who attempt to undermine confidence in private pensions by inaccurately portraying the financial status of the PBGC or of the private pension system do not serve the nation well.

Today, we must join together to build confidence in Social Security, private pensions, and the nation's commitment to retirement income adequacy.

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